Meeting of the Federal Open Market Committee
December 22, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 22, 1998, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist

Ms. Browne, Messrs. Cecchetti, Hakkio, Lindsey, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Ms. Johnson, Director, Division of International Finance, Board of Governors

Messrs. Alexander and Hooper, Deputy Directors, Division of International Finance, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Ms. Pianalto, First Vice President, Federal Reserve Bank of Cleveland

Messrs. Beebe, Eisenbeis, Goodfriend, Hunter, Lang, and Rolnick, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, Chicago, Philadelphia, and Minneapolis respectively

Mr. Gavin and Ms. Perelmuter, Vice Presidents, Federal Reserve Banks of St. Louis and New York respectively

Mr. Duca, Assistant Vice President, Federal Reserve Bank of Dallas

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CHAIRMAN GREENSPAN. A housekeeping item: We are releasing the minutes of the November meeting tomorrow, I believe.

MR. BERNARD. Tomorrow at 2:00 p.m., yes.

CHAIRMAN GREENSPAN. They are being released earlier than is our usual practice partly because of Christmas and partly because of coordination with the other central banks on the swap issue that we have discussed previously. Would somebody like to move the minutes of the November 17 meeting?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. Peter.

MR. FISHER. Thank you, Mr. Chairman. I will be referring to the four pages of colored charts you should find in front of you. 1/ Beginning on the first page with the deposit rates, you can see by the red lines in the top panel that the U.S. forward rates are little changed since your last meeting. But it is worth noting that both the 3-month and the 9-month forward rates continue to trade below the current 3-month deposit rate, suggesting some expectation of an ease coming in the first half of next year, but without much specificity to it. The two forward rates are trading on top of one another, so it does not look as if they imply a series of easings, but some further easing seems to be priced in here.

Looking at the German forward rates, you can see that those rates partially anticipated, in late November and into early December, the December 3rd Euroland rate cut. And the forward rates continued to drift a little lower after that. Also, the forward rates in Germany are trading below the current 3-month rate, suggesting again some expectation of an easing in the coming year. You can't see it in this chart, but let me note that there is very little evidence of greater year-end pressure this year than last year in German funding markets. It does seem to be worth noting, given the coming of the euro that the markets do not seem to have priced in any extraordinary year-end effect. That is also in contrast to the pronounced year-end effect we are seeing already for the year after next--for the year

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1/ Copies of the charts used by Mr. Fisher are appended to the transcript.

2000. So there's not much special pressure in German funding markets surrounding the anticipation of the euro.

In the bottom panel showing the Japanese rates, you can see that on this scale, which is comparable to the top two panels, the deposit rates show a barely detectable rise. But, as small as it is here on this chart, by Japanese standards this really is noticeable. Let me say that I think we have found too many, rather than too few, explanations for this gentle backing up in Japanese money market rates: whether it's that the economy is expected to bottom out in the first half of the year or that the yields on Japanese government bonds (JGBs) are backing up, as I will get to in a moment, or that the Bank of Japan is not being quite so generous in its provision of reserves. None of the explanations is entirely satisfactory to me, but there clearly has been a gradual backup in Japanese money market rates.

Turning to the second page, the three panels give something of a review of the last six months in financial markets. In the top panel, we have major exchange rate pairs indexed to 100 as of July 1st. It shows marks per dollar, yen per mark, and yen per dollar, and their percentage change over the last six months.

In the middle panel are the three major equity indices, also indexed to July 1st at 100. In the bottom panel, for the moment please ignore the red line which depicts the JGB yield; I will come back to that shortly. But the other three colored lines in that bottom panel show various spreads as they have traded from July to the present.

My point in bringing these three panels together is to show that there were really two very distinct episodes of delevering, which occurred roughly in the weeks following the Committee's August and September meetings. There has been a third more modest delevering event in the last few weeks associated with the year-end. The very pronounced decline in both the mark and the dollar against the yen seen in the top panel coincided with the significant turmoil in early October. You can see in the bottom panel that the three triangles point to the peak spreads reached also early in October. In the middle panel you can see where equity markets, at least in Germany and Japan, reached their nadirs during that period, and the Dow almost reached its nadir and began coming back.

More recently, there has been some gradual decline in the dollar against the yen, but it has been relatively muted, more or less associated with year-end thinness, with some reversal of that move in the last day or so. Also in the bottom panel you can see that swap spreads and the on-the-run/off-the-run spread have backed up a little. I would emphasize the thinness of markets rather than anything else here. But in the middle panel you can see the somewhat manic behavior of our equity markets. It seems to me rather pronounced and in contrast to the events in the other markets.

Focusing now on the red line in the bottom panel, which depicts the benchmark Japanese government bond yield, in the last few days--and since your last meeting in fact--there has been an extraordinary backup in this yield. The bond was trading at a yield of around 80 basis points at the time of your last meeting or just before. It traded at 150 basis points yesterday. It was off a further 40 basis points earlier today, or up to 190. It has come back a little from that level, having traded the limit down today both in the Tokyo and London futures markets, and it is now at about 180 basis points.

The Japanese government first began leaking and then yesterday announced its borrowing plans for the coming year, which in their forecast will amount to roughly a 65 percent increase in the amount of Japanese government bonds to be absorbed by the public portfolio--that is, by private sector demand. The bond market has begun to price this in.

Back in September Japanese banks were given a choice by the Ministry of Finance either to treat their bonds on a mark-to-market or on an original cost basis. Most of the banks, virtually all, elected to do it on an original cost basis. In my view, that simply is going to delay the day of reckoning as yields back up, given that the holdings of JGBs on the balance sheets of all kinds of financial intermediaries are rather significant as a credit substitute. As the yields back up and approach the average cost of any one institution's JGBs, that institution will have an extraordinary incentive to sell out its positions. That already seems to be under way and is providing something of a continuing accelerator for the backup in Japanese government bonds. Given the extraordinary scope of this backup in just a couple of days, I think it is reasonable that the U.S. and European bond markets have been backing up a little, as Japanese accounts experiencing these losses are off-loading some of their holdings of U.S. and other fixed-income instruments.

Now, all this is in anticipation of the rather exciting year Japanese government bond markets are going to have in 1999, so we have that to look forward to. We in all likelihood have the specter, in my humble opinion, of the Ministry of Finance trying to change the accounting rules again at the end of the fiscal year if these losses become too extreme on insurance company and bank balance sheets.

Turning to domestic operations on the next page, the funds market has been a little less stable than normal, but there has been some improvement over the last intermeeting period in terms of some reduction in the extreme volatility. This chart is similar to the one I presented at your last meeting. On the vertical axis are the basis points contained within one standard deviation of the daily trading range, and on the horizontal axis is the basis point variation of the daily effective rate from the target. The hollow dots represent observations in the intermeeting period between your September and November meetings. The filled in dots represent days since your last meeting. And as I did last time, I have summarized in the lower left-hand box the results, roughly speaking, against the benchmark period of the prior year before August.

As you can see, while we had fewer days with very low volatility, where trading was in a tight range around the expected rate, we had roughly the same number of days within the 50 percent box. Without counting the dots, let me point out a different way of looking at this. In the September-to-November period, fully 1/3 of the days observed had a standard deviation of greater than .4, whereas in the more recent period only 1/6 of the days had a standard deviation of more than .4. So we haven't come to the point of a quiet market, but we have reduced some of the extreme volatility. I think this has been caused by a reduction in credit concerns and some greater access to term funding markets, which have opened up to a wider number of participants. Also, early in this intermeeting period we leaned rather heavily against firmness, being quite generous in our reserve-supplying operations, and when we began to take that away from the market, it actually took the market a while to figure that out. They assumed, perhaps, that we were being more generous than we in fact were.

On the last page I have shown the comparable data for the same period exactly one year ago. I would note that the red dots represent the days with high payment flows--tax payment dates, bond settlement dates, or maintenance period settlement dates. They are really the days when one would expect to see the higher volatility, and that is what we see here. In the 1997 period the dots on normal days are much more densely clustered than in the comparable period this year, where we see a mix of blue and red dots at the higher volatilities, indicating the higher volatility we still are facing. But I think that has calmed down somewhat.

Let me note that we did conduct a pass to purchase indexed securities and we also undertook three longer-term repo operations. These elicited relatively little market reaction and went much as I had hoped. We already have $12 billion in repos on the books for the turn of the year, which will help us unwind automatically as reserve needs diminish after the peak year-end period.

Mr. Chairman, we had no foreign exchange intervention operations during the period. We have completed the renewal of our swap arrangements with our Mexican and Canadian colleagues, but all our other swap arrangements have lapsed. I will need two votes, however. I have circulated to the Committee a request to add the euro to the currencies in which we are authorized to operate. I would propose to come back to you at a meeting early in the new year to discuss removing the legacy currencies. But for the moment I thought we would leave those alone. So, I am seeking a vote to add the euro to the foreign currency authorization. I will also need ratification of our domestic operations. I would be happy to answer any questions.

CHAIRMAN GREENSPAN. Let me go back to the issue that you mentioned with respect to the incentives of Japanese banks to sell their JGBs. The banks are carrying them at book and they are engendering very large capital losses. Those losses are not being charged against capital, but would be if the JGBs were sold before maturity. I didn't quite get the point that you were making.

MR. FISHER. My understanding is that once the price of the JGBs declines below the cost at which they were purchased, the banks will have to recognize a loss.

CHAIRMAN GREENSPAN. Is it cost or market or both?

MR. FISHER. It is cost or market, whichever they chose. They were given a choice. Virtually all chose cost. I may be wrong, but I went over this with the Ministry of Finance representative in New York just yesterday, and my understanding is that once the market price reaches cost, the banks will then have to recognize a loss.

CHAIRMAN GREENSPAN. That is the old-fashioned market or cost basis if it's below market. Once they reach cost, it becomes a loss.

MR. FISHER. That's right. But I think the way they will view this is not on a bond-for-bond basis. They will look at the average cost of their JGB portfolio. And as the market price approaches that level, they will want to be liquidating the portfolio before the breakeven point is pierced.

CHAIRMAN GREENSPAN. Why? I can see it on a bond-by-bond basis. They may have a different way of keeping their books. We do it bond-by-bond; you are saying they do not.

VICE CHAIRMAN MCDONOUGH. I think there may be a distinction. The accounting probably is bond-by-bond. But if you are managing the portfolio, you are going to say: "It is approaching breakeven so I better get rid of it." I think the accounting would be the way you described, but the managerial approach would be to bunch these securities.

CHAIRMAN GREENSPAN. It is poor management if I understand what they are trying to do, which is to hide their losses.

MR. FISHER. Well, would it surprise you if that were--

CHAIRMAN GREENSPAN. I won't comment on that! On a seemingly related subject, I noticed that in the bottom graph on page 2 you show the U.S. 10-year swap spread over Treasuries, which is somewhat more than 80 basis points. In Britain it is also about the same order of magnitude. On the continent, as I recall, it is about 30 basis points. Does this reflect a presumption in the market that there is more sovereign backing of commercial bank liabilities on the continent than either here or in Britain? If that is not the answer, why is there such a significant difference in spreads?

MR. FISHER. I have not found an acceptable explanation of that myself. It is something I have tried to follow. So my first response is that I see it as a bit of a mystery. I think it's especially a mystery if you realize that these swap spreads, as most of us measure them, are from a common panel of major international banks. So the difference in spreads should be a credit issue, but it is hard to pull that out when one is looking at a common panel of global players who are the ones we look to for quotes on these swap spreads. That mean that is somehow embedded in--I don't even know how to express it. No term comes to mind to express this; I'm at a loss.

CHAIRMAN GREENSPAN. There has to be an answer because somebody is bidding 30 basis points for one and 80 basis points for another, which suggests that they see a difference and are doing it for a reason.

MR. FISHER. There are some in the market who think that European central banks are active in this market.

CHAIRMAN GREENSPAN. That is a potential explanation.

MR. FISHER. Yes, that would be.

CHAIRMAN GREENSPAN. That goes to the sovereign credit issue.

MR. FISHER. It is coming in through the demand side rather than the supply side, if you will. But I have not interrogated my foreign central bank counterparts enough to determine this.

CHAIRMAN GREENSPAN. If you have a chance, could you track it down?

MR. FISHER. Yes, I may be able to do so.

CHAIRMAN GREENSPAN. The only reason I raise the issue is that it may be telling us something about the issue of subsidization in the system, which is a useful insight if proven.

MR. FISHER. Yes, we will try to look into that further.

CHAIRMAN GREENSPAN. Any further questions?

MR. POOLE. Is this the appropriate time to bring up the issue of indexed bonds that we talked about last time?

CHAIRMAN GREENSPAN. Yes.

MR. POOLE. I happened to be on the morning call when the Desk first bought indexed bonds, and there was a very large reaction in the marketplace. It seems to me that this experience raises the question that I brought up before, about whether we should be buying indexed bonds for the FOMC portfolio. I am still opposed to it. In my view it produced a substantial change in the yields when we went in that day. I think our operations in this market are going to muddy the interpretation of the information we can get from the market.

MR. FISHER. You saw a rather significant 1-hour reaction, President Poole. I think the 1-day and 3-day and 3-week reaction was rather muted. So, my first point is that trying to measure this on a minute-by-minute basis involves working with too short a time horizon. My second point is that I really do not understand the logic of your position. We are active occasionally in purchasing securities on the other side of this spread whose purity you care about; we purchase 30-year and 10-year and 5-year nominal bonds. If what you care about is the clarity of the spread, the logical position is that we should operate either on both sides of that spread or on neither. I do not see the logic in suggesting that we should operate on only one side of the spread. I view the market reaction to which you refer as a short-term reaction to our first purchases of these securities. I would expect an abrupt reaction on the first day we operate in any new area of the market. But I think it largely disappeared and was very hard to find on subsequent days.

MR. POOLE. On the first day--not just the first hour, but the first day--the longest indexed bond, which I believe is the one that we purchased, was up 16/32. The neighboring bonds were down 12/32, 14/32, 19/32, and 20/32. In the general market that particular day the non-indexed conventional bonds also were dropping in price. As I understand the process, when the Desk is going to buy securities in the secondary market for the System portfolio, it asks for propositions from the market. And it is your standard practice to look for the propositions that are attractively priced from our perspective, and that means the ones that are a little out of line on the general yield curve. Would that be a correct interpretation of what you do?

MR. FISHER. That is one thing we look at; it is not the only thing. We are also looking at our holdings of securities and trying to keep a balanced portfolio across the whole yield curve. That is really the first order of importance.

MR. POOLE. Okay. I can understand picking up some that are trading at a peculiar price relative to the adjacent issues, but you can't make that decision on the indexed bond without taking a view as to what the relationship between the indexed bond and the conventional bond would be.

MR. FISHER. No, I disagree with you completely on that. That is precisely why I wanted to do a TIPS-only pass: So the only relative value statement we would be making would be vis-à-vis other TIPS issues. Thus, when we purchased TIPS I would make a judgment as to the rough order of magnitude, how many hundreds of millions should be purchased. Then the traders' judgments are restricted to making a relative value choice across the range of TIPS propositions they are given. That's precisely so we will not be making a comment on the appropriate spread relative to the nominal yield.

MR. POOLE. Mr. Chairman, I will only note that I am not convinced by the argument.

CHAIRMAN GREENSPAN. Let me suggest this: Why don't the two of you have a bilateral discussion and if you can add any additional light, report it to the rest of us.

MR. POOLE. That is certainly a reasonable proposition. Thank you.

CHAIRMAN GREENSPAN. Any further questions?

VICE CHAIRMAN MCDONOUGH. Move approval of the Desk's actions and adding the euro to the current list of designated currencies.

CHAIRMAN GREENSPAN. Without objection I assume approval of both. We now move on to Karen Johnson and Mike Prell.

MS. JOHNSON. We received October trade data after the Greenbook forecast was prepared, so I would like to start by describing the implications of those data for our understanding of the foreign sector during the current quarter. Both exports and imports surprised us on the upside, but the surprise was significantly greater for exports. In terms of trade categories, exports of machinery--other than computers--and industrial supplies both surprised us by the size of their increases. The miss was not in aircraft or other items where large-size transactions can introduce noise into monthly data. This surprising strength in exports may be a signal that recovery is proceeding a bit more rapidly in some parts of the world than we have allowed for in the forecast, but we have no direct evidence of that yet and hesitate to put too much weight on one month's trade data.

The October data nevertheless lead us to expect fairly robust growth of exports in the fourth quarter, after three quarters of decline. Combining stronger exports with a small revision to our outlook for imports results in a downward revision to our estimate for the quarter of the negative contribution of net exports to U.S. GDP growth from 0.7 percent at an annual rate to 0.3 percent. For 1999 and 2000, we still look for the drag from net exports to ease from about ½ percentage point next year to close to ¼ percentage point in 2000 after an estimated 1¼ percentage points for this year as a whole.

Our expectation that the drag exerted on real GDP growth by the external sector will diminish over the forecast period depends importantly on the modest rebound of exports that we are forecasting. The impetus for that rebound lies partly in the waning effects of past dollar appreciation and partly in the strengthening we anticipate in average foreign output growth, which has been exceptionally weak in 1998. In the Greenbook, the recovery in foreign growth entails a return to low but positive growth in the developing countries of Asia, some slowing in Latin America but not collapse, and a substantial reduction in the rate of decline in output in Japan. For each of these regions, our forecast is relatively conservative in that it is less optimistic than is the latest consensus forecast.

As in November, our outlook for developments abroad incorporates the assumption that the international financial package put together for Brazil, including successful implementation of the macroeconomic policies laid out in the IMF program, restores market confidence. As a consequence, although real activity in Brazil declines sharply, the Brazilian exchange rate regime remains in place and contagion to other economies in the region or elsewhere is kept to a minimum. As we indicated in the Greenbook, we view the risks to this baseline forecast of a less favorable outcome in Brazil as somewhat greater now in light of the failure of the Brazilian Congress to pass all the elements of a public sector pension reform package put before it earlier this month. Moreover, capital continues to flow out of Brazil on a net basis most days.

Last week, Brazil made an initial drawing on both the funds available through the IMF program and the funds available on a bilateral basis, for a total of just over $9 billion. These resources have been added to Brazil's international reserves. The Brazilian government has announced its intention to resubmit to the Congress next year the measures that did not pass in December and to proceed to implement the other elements of the IMF program. We look for those steps to put a halt to private net capital outflows and to contribute to improved financial market conditions, but we recognize that a return to crisis conditions in Brazil, and spillover to Argentina, Mexico, and other emerging markets, is still a distinct possibility. For that reason, we again included in the Greenbook an alternative scenario that incorporates a more pessimistic projection for Brazil, including a break in the exchange rate regime and the spread of contagion in Latin America. That scenario implies that U.S. real GDP growth would be ½ to ¾ percentage point lower in 1999 and 2000, respectively.

Mr. Prell will continue our presentation.

MR. PRELL. As Karen noted, the October trade report seems to point to a considerably higher level of net exports than was built into our Greenbook estimate of real GDP growth in the current quarter. However, yesterday we received the Monthly Treasury Statement (MTS) for November, and it points to lower federal purchases than we were expecting. The two adjustments are almost offsetting, leaving us now just a hair above the 3.1 percent GDP figure in last Wednesday's Greenbook.

That said, activity this quarter appears once again to have surpassed our previous forecasts. What is the explanation this time? Unfortunately, I can't give as neat an answer as I would like. Clearly, one piece of the story is our earlier underestimation of the rise in motor vehicle production, which accounts for about half the extra growth of GDP in the current quarter. Some of this reflects the automakers' competition for retail market share, but heavy trucks have been strong, too. Another piece of the story is that, while we thought that homebuilders had a sizable backlog of demand to meet, we couldn't foresee that the weather would be as cooperative as it has been. Builders have been able to keep workers on construction sites, avoiding a good part of the normal seasonal downswing in activity. Of course, the fact that this Committee chose to ease policy faster than we'd assumed hasn't hurt either the auto or the housing markets.

Beyond that, though, things get murkier. That's partly because of the incoherence of the current picture in the industrial sector, outside of motor vehicles. In particular, one might think from many company reports and surveys that the output of other manufacturers would be weaker than our industrial production estimates show them to be. But, to deepen the mystery, the IP data themselves are weaker over the second half of this year than would be suggested by the corresponding expenditure components of GDP. Perhaps subsequent data will narrow these gaps, but for now all this raises some question about just how strong the economy has been of late and it makes it more difficult to get a handle on the dynamics of the situation.

That brings me to the prospects for the further slowing of GDP growth in 1999. As you know, we're putting a lot of weight on the notion that accelerator effects should be shifting into reverse over the coming quarters. That is, the flatness of output growth for a while now implies that we should expect the level of investment to tend to stabilize.

As the perceptions of businesses and households regarding the prospects for their sales and incomes moved up in recent years, they presumably wanted to expand their stocks of capital goods to levels that would help provide the larger flows of production and consumption services. Spending on business equipment, houses, and consumer durables consequently rose markedly. At this point, though, such spending is so high that, even if it leveled off, the net additions to the stocks of these goods would remain substantial. For producer and consumer durables, declining relative prices likely will continue to elevate desired ratios of capital to output, but we doubt that it will be by enough to override this basic accelerator mechanism.

How can we be sure that this pattern will play out in the near term? We can't be. But the evidence of low capacity utilization and profit compression in many segments of manufacturing gives some concreteness to this model, and reports of companies actually planning to trim their capital outlays or seeking to take out capacity through mergers do give some credibility to the prediction. One might even be tempted to argue that the recent upside surprises in investment expenditures reinforce the case for anticipating a moderation going forward because they have further elevated the rate of capital accumulation. However, there are a couple of obvious retorts to this assertion. First, the mere fact that there have been surprises in investment spending underscores the imprecision of this analysis. It's not easy to gauge the desired stocks and the time profile of the adjustment processes. Second, the desired stocks can change over time for a variety of reasons. Among them are changes in the cost of capital or in household wealth, and in this regard the behavior of the equity markets has repeatedly confounded us in our forecasts.

The stock market remains a major wild card in the outlook. Heartened at least in part by what has been viewed as a supportive Fed, investors have been willing to stick with equities even as corporate earnings have declined. PE ratios have reached very high levels. Neither our earnings forecast nor our interest rate forecast would seem to justify a further rise in share prices over the next couple of years, and thus we're expecting that wealth effects will ebb, taking a good deal of the steam out of aggregate demand.

The behavior of stocks like eBay and Amazon.com might suggest that we're applying an obsolete paradigm for share valuation. But, it may be noted that the market as a whole really hasn't made much further headway on net since the early spring, when the year-on-year profit comparisons began to turn negative. We're essentially predicting that share prices will continue to fluctuate around the average level that has prevailed since that time. A continuation of crummy earnings and poor returns might provide the basis for a deeper market correction, but we're hesitant to predict it when the market has shown such a capacity for levitation and when we aren't anticipating any monetary policy tightening. Indeed, as our selection of alternative simulations in the Greenbook suggested, we wouldn't rule out a further rise in share prices, and another year or two of double-digit increases could trump the reverse accelerator effects that are key to our forecast. The market surge of the past three trading days is perhaps a sign in that regard.

Finally, a few words about the supply side of our forecast: The recent upside surprise in GDP growth does not appear to reflect any unexpected improvement in productivity trends. Rather, what we've seen has been consistent with the trend we have been assuming. So, going forward, our higher output path has translated into a lower unemployment rate. We've raised our inflation forecast, but not quite commensurately. Recent news on wages and prices has been favorable, even in the face of tighter labor markets and higher capacity utilization rates than we had anticipated would be prevailing. In addition, the prices of oil and other raw materials have fallen out of bed recently, and these lower input costs will be passing through the production pipeline for a while, in the process helping to hold down inflation expectations. One might question whether this commodity deflation is an unalloyed blessing in terms of international economic stability, but it is one more timely shock helping to check inflation here.

That completes our presentation, Mr. Chairman.

CHAIRMAN GREENSPAN. Karen, am I correct in assuming that the imports into the United States have been tracking under what our models would have suggested?

MS. JOHNSON. Yes, but not by much. The import equation has been doing fairly well.

CHAIRMAN GREENSPAN. So there is no evidence at this stage that the differences between income elasticities on the export and import side are showing any change from what we have seen over the years?

MS. JOHNSON. Not convincing evidence yet, no. The thought is in my mind, given the enormous changes in potential GDP growth everywhere. The fact that we see potential in the United States going up--and we certainly have written down the potential for Japan and other countries a great deal--suggests that whatever the deeply embedded fundamentals that give rise to these elasticities are, they may be changing, too. We can look at that question again, but there is nothing about the past six months or so of data that would cause one to think that that must be happening.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I have a comment and a question. First the comment: Karen, I would like to thank you for the memo on China that was done by John Fernald. It was very responsive to the questions I raised at the last meeting and also provided a lot of good information. It explained why China has performed better over this period, particularly since July of 1997. If any of my colleagues have not had an opportunity to read the memo, I would highly recommend it.

Second, in Part II of the Greenbook there was reference to an attempt by Boeing to make a lot of deliveries in the month of December. My recollection from the past has been that at times that has had impacts both on production and certainly on the composition of GDP, particularly if a lot of those deliveries were to foreign buyers. Can you tell me what some of the effects of that are likely to be and if they are included in the fourth-quarter numbers?

MR. PRELL. We try to track their production and delivery plans as closely as possible, with the help of some inside contacts. One of the uncertainties at this point is whether, indeed, they will be able to make the volume of deliveries to foreign customers that they hoped to make, because there seem to be financing problems still to be worked out.

MR. PARRY. So they end up in inventory?

MR. PRELL. They have been in inventory. We think those inventories are being reduced in this quarter, and that is part of our forecast. There is coherence in our arithmetic. In fact, in the ultimate GDP numbers--when we try to sort through all of this--we can't find the coherence that we have as we put these numbers together ourselves. So ex post, it is very hard to trace.

MR. PARRY. Right.

MR. PRELL., But, in terms of our forecast, we have taken into account their production intentions and their delivery patterns.

MR. PARRY. They are one of the few companies where a change in their sales can show up in the GDP numbers.

MR. PRELL. It is potentially significant on a quarter-to-quarter basis. I think we sometimes overestimate the importance of aircraft in total producers' durable expenditures in the United States, but certainly it can be a significant quarter-to-quarter swing factor.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. We had several area academic economists in for a meeting a week or so ago, including some from M.I.T. and Harvard, and I had some people from the investment community in for breakfast earlier this week. Almost everybody's projection for the fourth quarter is well above 3.1 percent. Many are hedging their bets, saying fourth-quarter growth is likely to be in the 3½ to 4½ percent range. But at least a couple of people who usually are on track on this had point projections above 4 percent. I wonder what you think about that type of projection and what it means for early 1999.

MR. PRELL. There is a lot of room to maneuver at this point with the data that are now in hand. I would not put 4½ percent out of the range of possibilities. They did not have the benefit of the MTS, though. That can be pretty tricky to read. We made that effort and it did chip a bit off the fourth-quarter number. Another possibility is that people have not interpreted the net export figures the same as we did. We have one month of data, the first month of the quarter. Does one extrapolate an upside surprise or anticipate an offset? I think Karen's colleagues scrutinize these data perhaps with greater care than others, but it is still very difficult to judge whether this component or that component will drop off. Finally, on that score, one needs to look also at whether there are offsets in domestic expenditures. Relative to what we had assumed, the net exports of capital goods were stronger in October than we had anticipated. That means less of the flow of shipments will be going to domestic customers. So there was a significant offset in producers' durable equipment expenditures as we did the adding up. But in the end one is looking at production indicators: employment, hours, the industrial production data, and so on. As we balanced these things out, we felt uncomfortable going higher than we did because there just seemed to be considerable tension. We wrote down a relatively low inventory investment number--much lower, I think, than did many of those outside forecasters. That is a product of this balancing act. We had some low October inventory numbers but there is still a lot of room for November and December to surprise us. That was one of the balancing factors. I suspect that if you looked at these other forecasts, you probably would not find inventory investment as low because others didn't feel as constrained as we felt by these production-side indicators.

MS. MINEHAN. So you think the balance of the risks is on the upside?

MR. PRELL. I guess I feel the fatter tail of this probability distribution is on that side. On the other hand, as I pointed out, there are inconsistencies in some of the information we are getting. It is really hard to determine where all these goods are that supposedly have been produced. Anecdotally, it does not sound right; and our own statistics just do not show it. And that is true over the second half of the year as a whole.

MS. MINEHAN. My own investigations in the last couple of weeks would suggest that they are in Bloomingdales! [Laughter]

MR. PRELL. In inventories for the time being, I take it.

CHAIRMAN GREENSPAN. Is that where all the steel is? [Laughter]

MS. MINEHAN. I don't know. There's lots of inventory there.

MR. PRELL. A lot of imported apparel.

CHAIRMAN GREENSPAN. Any further questions for either of our colleagues? If not, who would like to start our discussion? President Broaddus.

MR. BROADDUS. On balance, Mr. Chairman, the Fifth District economy appears to be continuing to expand at a moderate pace. Retailers are reporting very busy stores, brisk holiday sales, and the strength seems to be broadly based. Specialty stores and apparel shops, big box discounters, building supply stores, and hardware stores all appear to be doing very well.

told us that their credit card receivables increased more than 10 percent in November over October, which obviously is a huge increase. We are also hearing of increased strength in residential and commercial real estate. Local housing markets in Virginia, the two Carolinas, and particularly here in the District of Columbia are all stronger than they were a few weeks ago. Notably, institutional financing for office and retail space construction appears to have returned to at least some parts of the District after disappearing for a while in the third quarter as a result of the market turbulence.

On the other hand, our contacts in the manufacturing sector continue to report that District plants and factories are feeling the effects of lower commodity prices and increased foreign competition. As you know, we do a monthly manufacturing survey and it showed that employment dropped sharply in the manufacturing sector, particularly in the tobacco industry, machinery fabrication, and textiles. But on the more encouraging side, the survey also indicated that factory shipments rose in November to a level we have not seen for some time. We have a question in that survey about expectations of future shipments and, somewhat encouragingly, that figure rose in November for the first time since May. So, there may be some signs of a bottoming out in this sector, although the signs are still fairly weak.

As far as labor markets in our region are concerned, it's hard to believe but, if anything, they seem to be getting even tighter in the service sector, especially in the information technology sector. We get more reports of labor shortages now than we did a while back, and efforts to hire and retain workers are really very aggressive. They were already aggressive but, if anything, that aggressiveness has become even more visible recently.

At the national level, we agree with the staff that the most likely outcome in coming months is that real GDP growth will decline to a rate closer to trend. It certainly seems reasonable to expect business investment in particular to decelerate, given the prospective slowing in corporate earnings. But a good deal of the current momentum in consumer spending should carry through, underpinned by the recent strong growth in jobs and in real wages.

I think the important point here is that even if overall growth does in fact slow to trend, that will not necessarily relieve the current extraordinary tightness in labor markets. It will only stop the tightening that has been accompanying above trend real growth from increasing further. In other words, even with the slowing, we may still be above the maximum path on which the economy can grow without an increase in inflation at some point down the road. It certainly proves that inflation currently remains exceptionally well behaved. We can take some credit for that, I think, and we should. But some time next year the decline in commodity prices and in import prices of manufactured goods should end as Asian economies begin to heal. At that point, goods price inflation could well bottom out and begin to rise rather than offsetting the service price increases as has been the case recently.

With this in mind, and as we enter a period where our focus is shifting from trying to achieve price stability to trying to maintain price stability, I think we need to ask ourselves how we judge whether the policy choices we are making now are laying the foundation for continued low inflation or a resurgence of inflation, or for that matter deflation. The Greenbook forecast and the assumptions underlying it serve as the basis for the Committee's discussion of this crucial question at each meeting. Of course, the Greenbook, as we know, presents a forecast that is conditioned on a funds rate path. Presumably that path is the one the staff believes is consistent with the maintenance of the nearly stable price level we have now managed to achieve. In effect, the Greenbook prejudges to some extent where the funds rate needs to be. But it does not routinely present the core model and judgment used in arriving at that path for the funds rate, which makes it harder, for me at least, to evaluate whether the path is the appropriate one or not.

In the current situation, for example, the Greenbook projects that a constant funds rate at its present level would be consistent with no acceleration in core inflation over the next couple of years. I'm not necessarily criticizing that assumption; it is a reasonable assumption, I suppose. I'm just saying that I personally do not understand fully the basis for that assumption. It would be really helpful to see in more detail the core model and the analysis that is used in making that call. I don't mean to sound critical of the staff on this. In my opinion, the staff does a consistently fine job with a nearly impossible assignment. But I do think, especially in this new situation we face, that the Committee would be in a better position to make the best policy decision going forward if we could see a little more into the "green box," if I can put it that way.

MR. PRELL. Mr. Chairman, if I could just respond briefly. I am not sure I fully grasp the point that President Broaddus is making. I will follow up bilaterally with him to make sure I have an understanding. But just to be clear on the basis of our assumption for the funds rate, let me say that our default is to assume a stable funds rate unless we see when we run through our projection that we end up with an outcome that is glaringly at odds with what the Committee in its discussions and its policy decisions has suggested would be acceptable. Having listened to the discussions at recent meetings, people have basically said they would be very happy if we had an outcome like that. So, I do not have a sense that, with our forecast based on a stable funds rate assumption, we are giving you something that does not provide a baseline for discussion. Then, obviously, we try to give some indication of what different interest rate paths might produce. So, that is how we approach this. I hope that's helpful in some degree, but I will try to clarify it.

MR. BROADDUS. Let me just respond to that, Mike. You say you run it through the model. A more explicit discussion of how that is done and what judgments are made so we can feel comfortable with a constant funds rate in this forecast would be helpful to me.

MR. PRELL. That is going to be very difficult to portray because there is a good deal of judgment involved. In addition to the use of the quarterly model, we get input from sector experts and so on. As you know, we have invited Reserve Banks to send staff members--and they have--to join us during a portion of our forecasting process so that they can get a better handle on the various steps and the different inputs. If your Bank hasn't sent someone recently or if your staff's memory of what they saw has faded, we certainly invite you to send someone in the near future. I think that is perhaps the best way to understand what goes on.

MR. BROADDUS. Okay.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, economic activity in the Twelfth District has expanded at a solid pace in recent months, and our business contacts are less downbeat concerning growth prospects than they were during the summer and early fall. Total payroll employment has grown by 2.6 percent at an annual rate since midyear, above the 2 percent rate of growth in the rest of the country. California's expansion remains on track, and growth in the San Francisco Bay area picked up recently after slowing earlier in the year. Growth is rapid in several other states, with Nevada and Arizona ranked first and third in the national employment growth ranking.

Construction activity in the District has been robust. Construction employment has grown rapidly all year, largely due to strong demand for new homes. Although nonresidential construction plans have fallen a bit in the District this year, conditions in commercial real estate markets remain healthy, with low office vacancy rates in most areas of the District and only limited effects of the year's turmoil in the market for commercial real estate finance.

The ongoing slowdown in manufacturing is the weak spot in the District economy. After earlier gains that far outstripped the national pace, employment in District manufacturing has fallen since the first quarter. The role of East Asia has been critical. For example, the declines in California's exports to East Asia have worsened as the year has progressed. Relative to the same periods a year ago, California exports to East Asia in 1998 fell 12.7 percent in the first quarter, 17.5 percent in the first half, and 20.6 percent in the first nine months. Moreover, the employment situation at Boeing has exerted a moderating influence on the Washington State economy. This restraint will become more pronounced as Boeing implements a 20 percent cut in its workforce during the next two years. The impact on Boeing and its suppliers in the Los Angeles area already is evident in the loss of nearly 1,500 aircraft manufacturing jobs so far this year.

On the national front, just three months ago it appeared that the chance of a U.S recession, or at least a major slowdown, was uncomfortably high. This prospect, in my view, had shrunk noticeably by our November meeting and has fallen further since then. Although the economy faces substantial risks, the most likely outcome over the next year appears favorable. Recent data on economic activity in the third and fourth quarters have continued to follow the pattern of surprisingly strong output growth and low inflation that we've seen for about three years.

In addition to this factor, the outlook has improved since November because of our most recent funds rate cut, the better-than-expected economic performance in the rest of the world in the second half of this year, and the rebound in the stock market. Our forecast for real

GDP growth in 1999 has been revised up by ¾ percentage point to 2¾ percent under the assumption of no further change in either the funds rate or the U.S. stock market. We expect inflation to hold steady next year despite upward pressure from tight labor markets. The familiar list of favorable inflation factors seems likely to apply: robust productivity growth, ample industrial capacity, low commodity prices, and subdued inflation expectations. Overall, we expect inflation in the core CPI to come in at around 2¼ percent in 1999.

Although the most likely outcome for the economy next year appears favorable, the risks are large. The potential problems stemming from fragility in many Asian and Latin American economies as well as in international and domestic financial markets are obvious. But on the other side, the pattern of positive surprises in our economy could continue, especially in light of the very rapid growth in money and credit this year. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. Conditions in the Seventh District generally remain quite similar to what I reported in November, with the major difference being that the anxiety level among our contacts seems to have come down somewhat. Uncertainty about the domestic and global economies remains high, but the heightened concerns about credit availability that were so apparent in September and October have eased somewhat as a result of our actions to lower interest rates as well as similar moves taken by other central banks around the world.

Our District's economy continues to show trends similar to what I mentioned last time. Housing activity remains strong; consumer spending continues to be relatively healthy. Warmer-than-normal weather has helped maintain construction activity at high levels, but it has hurt sales of winter apparel, auto batteries, and snow removal equipment. More generally, sales so far this season have been reasonably good, though mixed by type of retailer. Department stores generally have been disappointed and have stepped up promotional activity. In contrast, the discounters, the specialty apparel chains, and home-oriented stores have reported strong sales. I guess Bloomingdales is not in that category! Light vehicle sales are expected to be strong again in December, boosted in part by especially intense competition between the Toyota Camry and the Honda Accord for best selling car of 1998.

On balance, manufacturing activity continues at a high level, with strength in some industries offsetting weakness in others. Reflecting these offsetting forces, the Chicago Purchasing Managers' Composite Index for December shows a slight pickup in overall activity from 50.2 percent in November to 50.9 percent in December. This information will not be released to the public until December 31, so it should be considered confidential until that time. Manufacturing contacts reported strong demand for aluminum, housing-related products, and both light and heavy motor vehicles. But weaknesses in foreign markets and low commodity prices continue to have an adverse impact on producers of oil-related products, steel, and agricultural equipment. One steel producer indicated that annual contracts now being negotiated with customers for 1999 are averaging a decline in prices of about 5 percent from 1998 levels.

More generally, conditions in the agricultural sector remain weak, particularly among hog producers, as has been widely publicized especially in our District. Hog prices in mid-December were almost 75 percent below a year ago, although retail prices have not fallen nearly as much. The price declines are largely due to substantial production hikes. The large operators are hoping that existing facilities will be grandfathered under potential legislation that is likely to limit future expansion due to environmental concerns.

Overall, price pressures remain benign. District labor markets are still tight, although the unemployment rate for our five states did edge up slightly last month to 3.7 percent from 3.6 percent in October.

Turning to the national outlook, our forecast is similar to that of the Greenbook. We hosted our annual economic outlook symposium earlier this month, and the consensus outlook from that group of 31 Midwest economists was quite similar as well. The strength of consumer demand has been very impressive of late and some slowing seems most likely. Despite heightened media attention to the low personal saving rate, wealth levels and confidence remain high and interest rates remain low. Therefore, we expect consumer spending growth to continue reasonably strong. The deterioration of the profits picture and, as Mike Prell mentioned, the lack of accelerator effects should cause investment spending growth to slow but only back to more normal levels.

So, overall, we expect aggregate demand to remain strong enough to keep labor markets quite tight. However, except for swings in energy prices, we do not see a noticeable pickup in inflation. Our chief downside concerns remain the poor prospects for growth abroad, the Brazilian situation that Karen Johnson discussed, and still somewhat fragile financial market conditions, although our policy actions appear to have helped settle the markets. Still, with the full effects of our recent policy actions yet to be felt, the risks to the outlook seem to be relatively balanced.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, local conditions in the Eighth District are largely unchanged.

I would note that comments from these sources are confidential, of course.

There is no question that the agricultural regions in our District are hurting. Many of the farmers have taken substantial losses. At this point their credit is not really impaired, although some may have problems obtaining credit for the next planting season. As a consequence of the weakness in the agricultural regions, there is a very pronounced slowing in the agricultural machinery sector. Sales of farm equipment are down substantially, and I think we see that in our national statistics. Homebuilding, without question, is strong except in the agricultural areas. We had a report from southern Indiana that homebuilders are on allocation for bricks, believe it or not. A contact in Kentucky reports that builders have a two-year backlog. I think that situation is generally quite typical in the urban areas. The labor market is very strong in most areas, again except in the agricultural regions.

On the national outlook, the staff forecast looks about right to me. However, I believe that our inflation risks are clearly on the upside rather than the downside. I continue to be concerned about the high rate of money growth. I wonder whether the staff outlook on investment is not giving enough weight to the very tight labor markets, which provide an incentive for firms to invest to substitute capital for labor. I think our traditional accelerator models may be missing the connection between the labor markets and business investment. That is all I have for now.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. There is not a whole lot new in New England, at least since the last Committee meeting. The regional economy continues to grow, albeit at a pace a bit lower than earlier in the year. Unemployment varies by state but in the aggregate is about a percentage point lower than in the rest of the country. Job growth, in contrast, is slower than in the nation as a whole, with New Hampshire having fewer jobs than a year ago for the second month in a row.

As I noted at the last meeting, some of this slowness in job growth reflects the region's demographic trends. Population in New England simply grows more slowly than in the rest of the nation. We frequently hear stories that growth in certain industries, medical care for example, is hampered by the lack of available labor supply. The fastest growing industries in the region continue to be construction, the general area of finance, and services. Manufacturing jobs declined in all six states again in October, reflecting a decrease, we think, in merchandise exports to the troubled Asian areas.

Defense-intensive industries by contrast added employment, even in the generally weaker environment for manufacturing. We think this is because national defense spending is scheduled to rise in real terms in fiscal year 1999 after more than a decade of decline. The jury is out on how this will affect the New England defense industry, but there is at least some prospect that major firms will hold their own.

Real estate markets, especially in Boston, remain relatively upbeat. Speculative construction has largely halted but some new space is coming on line nonetheless. Wall Street financing dried up during the late summer and fall market turmoil but other investors filled the gap, albeit at higher financing rates. Outside the Boston metropolitan area, both residential and commercial real estate markets are more mixed. Residential construction slowed a bit and new home sales were down despite the quite advantageous financing situation.

On the commercial side, Hartford continues to be soft. That probably explains in part the city's willingness to give away the store to the New England Patriots! But New Haven and Stamford, and the State of Rhode Island are all doing well. Lending at the region's largest banks remained quite strong, particularly on the commercial and industrial side, where quarterly annualized growth rates were 35 percent versus around 20 percent for the nation as a whole. This largely reflects growth in C&I lending at the Bank of Boston where customers chose to access credit lines in the fall when Wall Street financing became difficult or impossible to come by.

Finally, as I mentioned before, we held a meeting of the Bank's academic advisory council last week with several of the deans of the economics profession in attendance. Opinions in the group were divided about prospects for the economy. Some believed, based on this quarter's surprising strength, the tightness of labor markets, and the ease in monetary and financial conditions, that 1999 could test whether 3.9 percent unemployment is compatible with price stability. Others saw the risks more on the downside, with a negative saving rate, declining corporate profits, and the troubled external sector posing threats and trimming growth to rates below potential. However, there was almost no support for further near-term easing even among those who perceive the downside risks as significant. A wait-and-see policy was counseled. There also was concern that financial and especially stock market conditions might have been accorded too much weight in monetary policymaking of late.

Turning to the national outlook, we were pleased to see the change in the Greenbook forecast from November. The Greenbook now projects rates of GDP growth and levels of unemployment in 1999 that are quite close to our own. We differ a bit on the inflationary path, as we have over time. But we have been continually wrong in that area, so I must say I am a bit humble in that regard.

Overall, both the Greenbook and our own forecast describe an economic picture that may be the best of all possible outcomes: a relatively smooth slowdown in the expansion with very few downside risks, on the domestic front anyway. The question is whether this outcome will actually occur. Others have spoken about risks and I, too, think that there are large risks. And they occur on both sides. On the plus side, the momentum from 1998 could propel growth in 1999 and tighten labor markets further. In this scenario, consumers would not retrench and the negative impact of a slowing economy might not affect corporate profits as significantly. If this coincided with some luck on the external side--if Japan's growth, for example, turned slightly positive or the euro acted as a major positive for growth in "Euroland"--then conditions might be right for an even greater spurt of inflationary pressure than we project.

On the downside, and maybe more significant in terms of probability, growth could be slower if consumers did decide that the risks posed by higher layoffs, declining corporate profits, and a volatile stock market require them to save more and spend less than projected. Waning corporate profits could cause the stock market to decline sharply rather than to move roughly sideways, as we and the Greenbook have projected, and could encourage further consumer retrenchment. Bad luck on the external side--Brazil, for example--could well add to the negative effect.

As I consider these risks both on the upside and the downside, I must say I am struck by the high cost of being wrong. From where we are now, necessary policy changes to correct situations could well produce negative results, at least initially. If U.S. and world growth is stronger than projected, it seems inevitable that financial markets will soar and inflationary pressures will rise. The question will be whether we can intervene in time. Policy correction runs the not inconsiderable risk of producing a boom/bust scenario. If growth is slower, further easing might well be necessary. However, at least in the short run given current market conditions, an easing could propel markets to new highs only to risk a sharper correction later. The Greenbook forecast assumes no change in policy and our forecast does as well; and for right now that seems to be the best course. But I think we all better hope that the forecast is right because it seems, to me anyway, that the room to maneuver in the case of error is very small.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The regional economy in the Philadelphia District is healthy, although weakness in manufacturing persists. Attitudes are positive and prospects for continued expansion are good. Retail sales appear to be matching expectations. Consumers are shopping, though, with an eye for bargains. High-end brands that offer good values are moving while high-end brands that simply offer prestige are sitting on the shelf. Supermarkets have been responding to value-concerned consumers as well by upgrading the quality of their store brands while holding prices below those of nationally advertised brands. As a result--and I think this is an interesting statistic--the store-brand share of sales has risen recently to 25 percent from about 15 percent. Auto dealers report the same value consciousness because they have to offer discounts to move cars. Pressures on profit margins are mentioned frequently by business people. Wage costs are up some, but raising prices is not competitively feasible.

In commercial construction, there appears to be a reasonable balance of supply and demand. The rental market is strong and vacancy rates are low, but there are a few signs of overbuilding. The market is expected to stay on a solid footing, with vacancy rates stabilizing around 10 percent and with no building boom. All in all, the regional economy appears to be on track for moderate growth during the coming months, with labor markets tight and inflation in check.

For the national economy, I think we have an unusually wide spectrum of plausible outcomes. I can envision an economy that expands well above the Greenbook forecast. The economy has shown a lot of resiliency. There is an internal dynamic there that could provide the wherewithal for a surprisingly strong growth rate next year. I can also envision an economy that comes in on the weak side. There are vulnerabilities and we all know them; I don't need to tick them off. A combination of adverse factors could make for a very bearish performance. The Greenbook forecast is a reasonable guess among these wide-ranging alternatives. Who knows, it might actually come to pass, more or less. That is a compliment! [Laughter]

The good news is that we are operating in a low inflation, high employment environment that allows some maneuvering room for monetary policy should the unexpected occur. But in the current relative calm, we still need to stay awake and remain alert.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, over the past six weeks, the Sixth District has continued to grow at a healthy but slower rate than was the case earlier this year. We expect that same pace to continue into next year. The big stories this time around in our District are tourism and energy.

The outlook for Florida tourism has been noticeably less upbeat than it was earlier in the year. Negative fallout from the turbulence in foreign markets has adversely affected South Florida and the Gulf Coast. Particularly, there has been a falloff in Latin American tourism and there is concern that the middle-income tourist especially will opt not to come to Florida this year as evidenced by the bookings information at some moderately priced South Florida hotels. Although occupancy rates are up 1 to 2 percent from last year, 3-month forward bookings are off some 6 percent. There is further concern that a weak Canadian dollar will keep away tourists from Canada, a particularly important market for the west coast of Florida and the panhandle of the state. Even small declines in tourism are significant because of the sheer size and importance of the tourism industry, which dwarfs the entire economies of several smaller states in our District.

Declining energy prices are having depressing effects on Louisiana and other oil-producing parts of our District. State revenues in Louisiana are down significantly because of the drop in oil and severance taxes. It has been reported that the price of a barrel of crude is only 25 cents less than the price of a barrel of gasoline, and a gallon of gasoline now costs less than a gallon of bottled water! The result has been a steep decline in drilling activity. The rig count in our area is down to 150 from a high of about 210. It is having its effect on supply boats and other support activities. There also is concern about the merger announced between Exxon and Mobil, which could put as many as 10,000 Louisiana jobs at risk. And yet, Bob McTeer, those jobs are likely to show up in the State of Texas.

Finally, although payroll employment growth has slowed, labor markets remain extremely tight. There is still concern about rising wages but the bigger concern, as others have said, relates to the availability and quality of the remaining workers. The only area where there is significant evidence of price increases is in health care where costs are expected to increase at a double-digit rate for many large employers.

At the national level, our broad outlook, like others, is not markedly different from the Greenbook but with some differences in composition. I expect some slowing in consumer spending, business fixed investment, and housing, but to date there is little concrete evidence that those trends are beginning to develop. Indeed, the near-term outlook is more positive now, given the revisions to the estimated third-quarter GDP and the likelihood of a strong fourth quarter as well.

My view is that the more pessimistic forecasts may be giving too much weight to further deterioration in the international sector and its implications for U.S. growth. It is my sense that we probably have already experienced the brunt of the declines that will take place and that our domestic economy remains quite strong. Employment growth continues at a strong pace; unemployment is down; consumer incomes are up; and energy, steel, and other commodity input prices continue to come down. The view that declining corporate earnings projections will both damp investment expenditures and depress share prices, thereby cutting back on consumer spending, implies stronger impact multipliers than we have seen to date. Interestingly, some of our recent research shows much less of a direct relationship between corporate profits and real GDP growth than one might intuitively expect.

Additionally, the effects of the past three rate cuts have not yet fully worked their way through the economy. Our model simulation suggests that only 40 percent of a policy move's total effect on GDP occurs within two quarters and that it takes some six quarters before 80 percent of its effect is reflected.

As others have suggested, the largest downside risk seems to be in Latin America. Clearly, a major key lies in whether there is further financial turmoil in Brazil, whether authorities there can engineer an orderly depreciation of the real, which would permit an easing of interest rates, and whether any currency depreciation will be supported and accommodated peacefully by Brazil's multilateral creditors. However, should Brazil experience another crisis, the regional outlook will suffer if contagion spreads to other Latin American markets.

Putting everything together, I think we have a good chance of a moderate slowdown in near-term growth going forward. Despite the fact that the risks to the economy remain large and may even be larger because of recent events, I see the risks as being relatively balanced and symmetric at the current time. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. At the broadest level, the District economy remains healthy. There is very little question that it is continuing to expand. But that generalization applies principally to the major metropolitan areas where construction, both residential and nonresidential, is strong and consumer spending is robust. Labor markets remain very tight and there are clear signs of wage pressures, especially for entry-level jobs where firms have to bid up salaries in order to attract people.

On the other hand, parts of the District that have been struggling for some time continue to struggle. Agriculture, and especially livestock, is one example of that; mining and the energy sector are a second; and parts of the manufacturing economy are a third. I would say that in those sectors, if anything, the problems have become more significant and attitudes have deteriorated a bit further. Of course, most people and the bulk of the economic activities are in the major metropolitan areas, so in trying to put this together one doesn't want to exaggerate some of those out-state problems, as it were.

As far as the national economy is concerned, two aspects of it have struck me for some time. One is its resilience. If you think about the events that have buffeted the national economy over the last 10 or more years and counterpose that with its performance, there is no question that resilience has been a characteristic of this economy. The other somewhat related aspect is that while we clearly have had a lot of turmoil coming from abroad, principally in the last 18 months or so, the economy seems on net to have weathered that well. Of course, when you cut through it all, those developments are not entirely negative either in terms of their implications for interest rates and inflation or for the interest-sensitive sectors of our economy.

I think the outlook for the economy in general is positive in terms of sustainable real growth. There are a couple of significant downside risks that people have commented on. One is the Brazilian situation and another is, at least in some people's judgment, an excessively elevated equity price. But I don't know what probabilities to attach to possible corrections in those situations. In fact, it is my view that we probably will get more real growth or at least more growth in aggregate demand than is indicated in the Greenbook over the next year or two.

Taken by itself that is certainly positive. The question is what rate of inflation is likely to accompany it. So far at least, the surprises in the inflation numbers have been on the downside and that is to the good. And the weakness in commodity prices suggests that that may continue.

On the other hand, I must say that the rapid growth in the monetary aggregates and generally accommodative credit conditions do give me some pause. They are a source of at least some potential concern. At a minimum we need to monitor that closely.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Texas employment growth has decelerated from fast to moderate during the course of 1998--from about 4.6 percent in 1997 down to about 2 percent lately. Three head winds or drags are causing this growth to moderate. One is tight labor markets. They have been tight for a long time, but we have less and less ability to attract workers into Texas from the rest of the country because the markets are tight everywhere now.

The low oil prices that Jack Guynn mentioned have hit us very hard. Incidentally, our contacts expect oil prices to remain very low for longer than the futures markets are suggesting. In our District, extraction employment has declined by about 5,000 and the rig count has declined around 37 percent. Of course, low oil prices are not nearly as harmful to our region of the country now as they were back in 1986. Not only are we more diversified, but we have more energy-using industries that benefit from low oil prices than we did then.

Another factor slowing our economy is the weakened state of foreign markets for Texas exporters. Earlier, in late 1997 and early 1998, there was a sharp decline in exports to Asia. That decline is pretty much over; there is still a slight movement down in the trend line, but it's almost flat now. Added to it, however, have been some declines in our exports to Canada and to Mexico and Latin America more generally.

On the national economic scene, I don't really have any new or unique insights to offer. The main point I would make is that while some risks are associated with the strong momentum in the real economy at year-end--as evidenced by the possible reversal of the net export drag, the continued tight labor markets, and rapid money growth--those developments continue to occur in the context of worldwide deflationary pressures and in particular a continuing decline in commodity prices, even since our last meeting.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. There are disparate developments in our District as well as all over the country. In particular, directors and others we talk to focus attention on steel and how hard times have been for the steel sector. Twenty years ago when I lived in Pittsburgh, one of the large corporations headquartered there was among the largest in the world--the United States Steel Corporation. They decided they were too dependent on steel so they diversified into oil. [Laughter]

CHAIRMAN GREENSPAN. That's how they got there in the first place!

MR. JORDAN. So, we do hear those stories about just how difficult it is for certain companies and certain communities that are related to either metals or energy. But virtually everything else is about as strong as it can get, and everybody talks about 1999 being even stronger. The motor vehicle industry is exceptionally strong. Mike Moskow mentioned Honda and Camry; they are both produced in our District. In fact, four of the top six selling automobiles are produced in our District and three of the top selling so-called light trucks are produced in our District. So, employment in that industry is strong and the automobile producers would like it to get stronger if they could find the workers. Toyota announced last week that they are going to develop 86 acres in northern Kentucky across from Cincinnati and build an

840,000 square foot facility, and they are going to import the labor from somewhere. Most of the communities around the District talk about importing labor from someplace else.

Expectations generally are that holiday retail sales will be excellent; the malls are packed. People are earning good incomes and they are spending. In banking, C&I loan demand is reported by one director to be the strongest that he can recall in the time he has been in the banking industry. Bankers have expressed concern about the continued overbuilding of retail space and hotel and motel space. They also worry that depressed commodity prices are eventually going to depress farmland prices, but they continue to report that for the moment farmland prices keep going up. One director with the construction workers' union said that labor shortages are going to worsen in the region in 1999 because of all of the new projects. One director in the asset management business reported that the equity market is being driven by what he calls "perpetual great expectations," which he considers to be unrealistic. He voiced concern that company pension plans and individual retirement plans have been increasing the share allocated to equities in recent months. I have seen--probably everyone has now seen--newsletters, advisory letters, talking heads on CNBC, and so on saying that there is no risk that the stock market is going to go down because if it even started down, the Fed would ease policy to prop it back up. So, in their view, the market can only go up from this point. I think there are more and more people coming to that belief and acting on it.

One note in retail distribution that I found interesting is that catalog sales are reported to be growing at very rapid rates and that sales to corporations for promotions and gifts are extremely strong. It was noted that apparel sales are now the fourth largest category of Internet sales, accounting for 23 percent of total sales on the Internet and rising at double-digit rates of increase. reported that his company plans to raise wages 10 to 12 percent across the board in 1999 in order to reduce their reliance on temporary workers and to lower the turnover of their work force. And while they are doing that, they plan to invest heavily in labor-saving equipment.

Since the last meeting, I had an opportunity to be in a more tropical climate than Cleveland. Of course, Cleveland has been somewhat tropical this year. I had daily reminders of what somebody once said: "Inflation is like bananas. Once you start to see the brown spots, it's too late." [Laughter]

CHAIRMAN GREENSPAN. A very soft report!

MR. JORDAN. So, we all look for signs and evidence that prices of goods and services are starting to rise at a somewhat more rapid rate. There are some signs, and the staff forecast for the next year or two is that the rate will be modestly higher. But even if that forecast is accurate and prices of goods and services rise only moderately faster in the next couple of years, low measured inflation is a necessary but not a sufficient condition for monetary stability. We and others around the world have experienced monetary and financial instability and ultimate economic difficulties even during extended periods when prices of goods and services were rising only very slowly. So in an important sense, stabilizing the dollar involves more than just wages or prices of goods and services.

We all know that equity prices cannot continue to rise at double-digit rates as they have over the last few years. Forecasting an end to that in one sense is easy. There is no such thing as: The change in the rate of change can increase indefinitely. Inevitably, the rate of increase in equity prices must slow, and I would have been happier in that regard if we hadn't had this recent very strong rebound in equity prices from the lows of last fall. We also know that the rates of growth of the whole constellation of measures of money are going to have to slow.

They have accelerated dramatically; they will moderate. Somehow, someway, their growth must slow. Either we'll get lucky and they will slow or we'll take action to slow them down. We know the growth of bank credit and all of its components cannot continue to rise at double-digit rates. It must slow down, sometime, someway. We know that the rate of increase in real estate prices--house prices, commercial real estate prices, and farm prices that have all been accelerating--must slow. There must be a deceleration, a negative second difference. So, we know these things are in our future. It's just a matter of when and how we get there.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, our District economy continues to chug along at a pretty good pace. We have some weak areas, and one of those, of course, is agriculture. The impact is not as dramatic as I mentioned last time because of the recent transfer payments to that sector. The concern is the longer term. We don't know what the Freedom to Farm Bill will mean or whether transfer payments will have to increase in the future if these price pressures continue. That is an issue in our part of the country.

The other weak area is energy. Obviously, the low price of oil is hurting our District economy right now, although we, like others, are more diversified now. Of course, mining, especially the coal industry, is under a lot of pressure; capacity and price pressures are quite damaging to that industry right now, I am told.

Conditions in the manufacturing sector are more mixed in our region. Activity in some manufacturing industries is slowing as a result of competition with foreign, especially Asian, products. Our electronic components manufacturers are feeling some pressure. On the other hand, our auto industry is doing well as are some of our metals manufacturers that are exporting. They have worked very hard to increase their productivity and they probably are going to have their best year ever in some instances. So, we see mixed signals in the manufacturing sector.

Of course, housing is strong as are services, including retail. Our banking industry is quite active right now. Our banks are competing very vigorously for loans and they are competing on price. They tell me their margins are certainly narrowing as a result. We continue to have tight labor markets. There is some relief perhaps around the edges in some of the manufacturing industries that have seen a slowdown. But as a general principle, labor markets are still very tight.

As for the national outlook, I would describe our view as having come closer to the notion that growth will slow toward trend because of two factors that are not completely predictable. I think we will have very strong domestic demand going forward. We have the continuing impact of recent rate cuts, and M2 growth is quite strong. I think those portend a stronger economy and some future upside risks for the economy. Obviously, though, capacity has increased in the economy and that will help restrain some of the price increases. We also have the external sector exerting deflationary pressures and we see many uncertainties with situations like Brazil. So balancing out those two effects, I would say that growth will come back toward trend but that the upside risks are noticeable.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The Second District's economy has generally shown increasing signs of strength in the past month. Private sector job growth in both New York and New Jersey accelerated modestly in November. The unemployment rate held steady at 5.1 percent. Purchasing managers when surveyed say that they see some strengthening in manufacturing. The purchasing managers also saw continued brisk growth in the nonmanufacturing sectors in the month of November. Our part of the country is really not very dependent on trade with Asia; the trade flows are in other directions. The retailers, as in most parts of the country, report that sales are below plan, especially in winter outerwear. Manhattan's office market, which has been very strong, is showing some signs of softening in the fourth quarter: Office vacancy rates picked up a little in October and November and price increases slowed. The purchase prices for other commercial properties turned down. That is probably very closely related to the weakness in the financial services sector in the third quarter.

We think the domestic economy is well balanced and should grow at about trend or slightly below in 1999 and 2000. This expected slowdown is likely to keep inflationary pressures under control on the assumption that we will maintain the present policy stance. Foreign influences are likely to continue negative, with Brazil clearly the major danger and one that is growing, unfortunately. Our policy actions this fall--our three reductions in official rates and the related though not coordinated reduction in interest rates in Euroland--have helped reduce the considerable danger in fixed income markets. The likelihood that both the Federal Reserve and the European Central Bank will maintain official interest rates for the early months if not a bit longer next year is a very good background for a successful introduction of the euro. And I think that will have a somewhat stabilizing influence. It is much to be hoped that the transition will go smoothly. If it does not, since it is so much easier than the year 2000 transition, I think it would increase the anxiety level considerably for the Y2K change.
The New York Reserve Bank's board, which had been very much in favor of our policy easing actions as indicated by voting twice for a reduction in the discount rate, has shifted its position, as I believe it should have. Their thinking now is that it is very important for the Federal

Reserve to show that it accomplished what it sought to accomplish and that further easing actions should take place only if there is clear and new evidence of weakness.

I think the risks are very well balanced now. The fixed income markets have not completely returned to normal but I think we could expect, Brazil permitting, that they will probably return to somewhat greater normalcy as we get past the year-end and into 1999. The domestic economy probably has a little more threat--in a nice sense--of being stronger if left to its own devices, but the dangers from the emerging markets are still sufficient for me to view the overall risks as very well balanced. To me that does encourage us to maintain the position of watchful waiting as the appropriate policy stance.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, the Greenbook and most forecasts foresee a slowing in the U.S. economy. I share that view because, after all, as we've heard this morning, the manufacturing sector is slowing and related to that net exports continue to deteriorate, although we hope the rate of change will decelerate. Consumer savings have gone all the way into negative territory, and for that and other reasons consumption seems sure to slow. Investment has been on a tear for a long time. That seems bound at least to moderate to a more normal pace. Profits are already slowing, which implies risks to the stock market and an attendant wealth effect. And so forth.

However, what do we see going on around us? The fourth quarter of 1998 appears to be substantially stronger than we had earlier believed, giving the economy a lot of momentum going into 1999. Interest rates have been coming down since our last meeting. The effects on the real economy of our earlier rate reductions are only beginning to kick in. The dollar is a little weaker, which will be stimulative if it continues, as it is forecasted to do. New job creation continues to be strong. Unemployment is actually going lower it would appear. Consumer sentiment remains high. Retail sales are strong, particularly in the cyclically sensitive areas like housing and autos. With an important possible exception of Brazil, which many have mentioned, foreign financial pressures on the real economies in many areas seem to be easing at least for now. To date, there has been no great change evident in the pattern of inflation.

All in all, Mr. Chairman, at this moment I am not at all clear in which direction the next policy move should be, let alone when it should occur.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. Our job all year has been to try to bring about a soft landing. In the first half of the year it looked as if we might never have any landing at all. In the second half of the year a crash landing seemed more likely. Now, for one of the first times this year, conditions look about right. One can take either the Greenbook forecast or the Blue Chip forecast and it is hard to write down a better scenario for a soft landing. In that sense, I am relatively comfortable with the present stance of policy. There are risks. Others have talked a lot about the risks and I don't have anything in particular to add except that it seems that the risks will become more evident over time and we will have time to act against them, provided that we are willing to use monetary policy in a flexible way.

Others have talked about the money supply and I don't have much to add about that either, except to note that there could be a variety of special factors influencing the rapid growth of the money supply. Those who worry a lot about money supply have to admit that the money supply would have been a particularly poor guide to policy this year. That doesn't mean it will be from now on, but if we look at it in retrospect I think it would have been.

I would like to take the opportunity to talk a bit about monetary policy strategy and in particular about a memo that we all get called "Monetary Policy Rules," which I hardly ever hear referred to. It relates to the Taylor Rule, which is actually quite a favorite among the academic economists. I have been looking at that rather hard this year and, in my view, it has not been that helpful. For most of the year, if one looked at its various predictions, it could have been interpreted as arguing for higher or lower interest rates, depending on how one estimates the equation and some other technicalities. Now it seems to be saying that we should be raising interest rates when one could make a case that interest rates are about right. I think the problem here is the output gap term. And the deeper problem is that to apply this rule, we must have point estimates of our targets for both inflation and unemployment. At the very best I think we have bands; we do not have point estimates.

As one listens to the way all of you talk about monetary policy, you seem to have different approaches to how to think about it. Suppose for the sake of argument that inflation and unemployment are reasonably within their target bands if not at one's point estimates. As long as inflation is neither accelerating nor decelerating, we seem to be striving to maintain existing conditions. Partly this involves watchful waiting on acceleration or deceleration, not necessarily on inflation as such but on leading indicators of inflation such as those on the output side. And in part this involves aiming policy so that future growth in aggregate demand equals the trend growth in aggregate supply, which is roughly 2½ percent under most models. At the last meeting, I said that the trend growth in aggregate demand was too low and that the economy needed some further stimulus. At this meeting it looks about right--at least to me, maybe not to some others. But I think that most of us have this more informal way of keeping things on an even keel for stable noninflationary growth. I believe this is what most of us do and I think it is working. Thank you.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. In view of the unusual constellation of real economic and financial conditions, both domestic and international, I believe the outlook for the economy is "murky," which I think is the word Mike Prell used. I would say it's perhaps even murkier than the staff presentation might suggest. The data released in the last few weeks do indicate that the economy entered the final quarter of 1998 with substantial, and I think perhaps even surprising, forward momentum. Real GDP growth was revised up for the third quarter and the Greenbook shows that the staff forecast for the fourth quarter also has been revised up based on early information. As Governor Gramlich indicated, both the staff forecast and broad consensus forecasts show significant abatement of this growth in the early part of 1999 with a bit of below trend growth and then returning to what is described as a soft landing with low inflation.

As others have said, and it's a view I endorse, there are numerous risks to this outlook. The downside risks are quite clear and I will not repeat all of them except to point out two. One is that Japan's economy is remarkably weak and seems to be experiencing what I can only describe as real crowding out in which their long-term interest rates seem to be going up as the government attempts to stimulate the economy through fiscal actions. Secondly, as Vice Chairman McDonough remarked, Europe is about to enter a very new and interesting phase that I think is going to test their ability to have the right amount of flexibility in both monetary policy and fiscal policy. Thus far, they have shown good flexibility with respect to monetary policy, but they may not have as much room on the fiscal side. So, there are some risks because Europe's economy seems to be slowing somewhat.

While these downside risks are real, I am also concerned about the upside risks. Others have mentioned this. As President Boehne indicated, the staff's scenario is plausible and might even happen. I certainly hope that it does. But the economy has surprised us continuously with the upside capabilities it has shown. And next year, we are going to face a situation in which there will be a waning impact of the dollar's appreciation and there may be some surprises with respect to economic growth abroad. And though oil prices are now low, there is a possibility that they may turn upward, and that may undercut a bit the benefits we have had over the last couple of years.

In this world of risks on both sides--and I do believe they are balanced--I think the current posture of monetary policy is probably about correct. If the inflation forecasts prove accurate, we can afford to adopt a wait-and-see posture. We have shown that we are prepared to move quickly and forcefully to offset downside concerns. If it becomes necessary, and I don't know that it will, I hope we can move as forcefully to offset upside risks. For now, though, my two watchwords are "caution" and "vigilance." Thank you.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. Let me make three general points about the situation we find ourselves in at year-end. One is that the continued sterling performance of the U.S. economy is really remarkable, and it is going to be worthy of some serious scholarly attention for some time to come. A year or two ago the press, economists gathered at meetings, and even the FOMC were full of talk about a possible new era. We did not all endorse it, but we all talked about it. Some of us were trying to explain how labor markets could remain so tight without causing wage inflation to accelerate. Others were suggesting that some combination of the long heralded but unrealized impact of information technology on production plus the new competitiveness of management had put the U.S. economy on a higher productivity trend.

Then we all got distracted by the worldwide economic crisis and our effort to maintain our island of prosperity in the midst of global turmoil for the world's sake as well as our own. But while we were distracted, the U.S. economy continued to chug along, pumping out goods and services, making better and better use of limited labor supply, rewarding skill with wages that provided incentives to acquire more skill, handing out bonuses to high performers, but not shifting into the mode of general wage inflation. Moreover, good productivity growth continued even in manufacturing where demand slackened and payrolls were falling. The urge to modernize and computerize remained robust in the face of macroeconomic forecasts that might have prompted retrenchment in earlier eras. The U.S. economy really does seem to be working better than it used to work. It is more flexible; it is less inflation prone. The good performance is more remarkable the longer it continues.

Second point: It is possible that one of the things we all thought we knew about monetary policy has to be unlearned, namely that it operates with very long lags. Jack Guynn referred to this in the opposite direction, but I don't think he and I are saying anything inconsistent. He was reminding us that the full effects of the policy moves of the last couple of months have not yet been felt, something we would not have needed to be reminded of a few years ago. We would not have expected the effects to be completely incorporated yet.

We used to think that central bankers had to take big leaps into the dark because our policy instrument, while powerful in the long run, affected the economy only over periods of 6 to 18 months or more. But now we find ourselves with a tool that seems to work faster. Our actions in September through November are credited with strengthening--or sometimes credited with overheating--the U.S. economy in the current quarter, not to mention the prospects for the first half of next year. One reason is the increased importance of equity markets both in financing business expansion and more importantly in enhancing consumer wealth. I think the wealth effect is not going to be temporary. It will only become more important as prosperity and longer lifespans combine to increase the portfolio of the average family. That is not so true in Europe yet, but it surely will be in the coming decade and elsewhere around the world as well. So, we have to learn to accept wealth impacts on consumer behavior as an increasingly important aspect of the monetary equation.

Another phenomenon that has cut the lags is the growing importance of consumer credit and home mortgages. The ease of refinancing home mortgages and home equity loans makes the transmission of monetary policy moves into consumer behavior more direct and faster. The growth of global equity flows and sensitivity of global markets to information also magnifies the effect of policy moves by the world's important central banks, namely us and the soon to be created ECB. So, we have a hotter instrument in our hands than we used to have and we had better get used to it.

Third point: The world is still a scary place. I won't argue with the Greenbook forecast, but I believe we will all be lucky if it comes to pass. While there are some upside risks, which have been mentioned, it seems to me that the risks are mostly on the downside. There is Brazil, which is still very uncertain. There is Russia, where more chaos is possible and the world community seems absolutely paralyzed about what to do. There is Japan, where the worst may be over, but we have said that a lot of times before and the possibility of a spiral of deflation is also there. And there are countries all around the world that we have not focused on. There is also an uneasy knowledge that whatever blows up next, the turmoil will spread rapidly through world markets in unpredictable ways. So, despite my optimism about the fundamentals at home, I think we had better look carefully for world trouble and hope that we know enough to use our increasingly short-lagged policy tool appropriately if we have to.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. Like most forecasters, I responded to the downward revision in foreign growth prospects and the abrupt deterioration in domestic financial conditions after midyear by revising down my expectations for U.S. growth over 1999. Unlike most forecasters, I was in the position to ratify my earlier forecast by participating in monetary policy decisions to lower the funds rate by 75 basis points. I appreciate being in this unique position. [Laughter]

But monetary policy actions have not been the only developments that have supported an upward revision to expectations for growth next year. Three other developments are of note. First, the stronger-than-anticipated growth in the second half, maintaining the continuous pattern of positive demand surprises over the past three years, is evidence of continued resilience in demand and suggests greater momentum going forward and upside risks to the forecast for next year. Second, the external drag from declining net exports appears to be diminishing faster than expected. After subtracting more than 2 percentage points from growth in the first half, net exports appear to be subtracting only ½ percentage point in the second half. Third, the deterioration of financial conditions that seemed so worrisome a short time ago now appears less so. The equity market correction has simply disappeared. While private risk spreads have widened in the capital markets, the absolute level of private borrowing costs, weighted across risk classes, is about what it was at the end of last year and only modestly above lows for the year reached at about midyear.

On balance, financial conditions, thanks in part to recent monetary policy actions, continue to be supportive of growth going forward. There are nevertheless plausible grounds for projecting a slowing of growth. The rationale for the slowdown is well presented in the Greenbook, though it should be admitted that virtually all the arguments, including the dissipation of the positive stimulus from the wealth effect, the dissipation of accelerator effects, etc., were considerations that underpinned the projected slowdown for 1998.

On balance, I expect growth to slow to about 2¼ percent in 1999 and I see a somewhat better balance now in upside and downside risks. I think the upside risks principally reflect the experience of continued positive demand shocks that after some point make me wonder what we might be missing about the fundamentals driving this expansion. The downside risks have been well discussed around this table. They relate principally to Brazil, to questions about the sustainability of current equity prices, and to other pressure spots in the world economy.

Let me note two upside risks relative to the staff's inflation forecast. As I have noted at recent meetings, I find the Greenbook forecast of a slowing in nominal wage growth somewhat aggressive. The risk here can perhaps be seen by comparing the forecasts for nominal wage change based on wage-price and wage-wage versions of the Phillips curve, two specifications that are routinely tracked by the staff. The forecasts for the wage-price specification point to a slowing of nominal wage changes going forward--and perhaps a significant slowing--as the response to the recent decline in inflation and the projected modest rise in the unemployment rate dominate the effect of the prevailing low level of the unemployment rate. Some of the wage-price specifications indicate a slowing of as much as a percentage point in the rate of nominal wage gains in 1999. On the other hand, the forecasts from the wage-wage specifications suggest a sizable increase in the pace of nominal wage gains going forward. Both of these specifications have yielded similar errors over the past four years, and they are now generating forecasts that differ by as much as 1½ percentage points over 1999. I think this highlights the considerable uncertainty about inflation going forward.

Second, the Greenbook allows for some diminution in the favorable factors that have been suppressing inflation: a reversal of declines in oil prices; some further depreciation of the dollar; a reversal of the recent decline in non-oil commodity prices; and a faster pace of increase in health care and health benefit costs. The dissipation of the contribution from these special factors is the basis for the convergence of actual to core inflation in the Greenbook forecast. But I am concerned that the projected rebounds in these components could result in somewhat higher inflation than in the staff forecast and that in addition there is a particular upside risk from a sharper-than-projected depreciation of the dollar. Thank you.

CHAIRMAN GREENSPAN. Thank you. I think we have ended as close to 11:00 as we have in a very long time. I assume coffee is out there.

MR. BERNARD. Yes.

CHAIRMAN GREENSPAN. We are on schedule for a change.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

MR. KOHN. Thank you, Mr. Chairman. The announcement of your last easing suggested that, as a consequence, the federal funds rate might be positioned to sustain growth and keep inflation contained. The incoming information since then could be seen as reinforcing that judgment, at least for now. Economic activity has been stronger than expected and the unemployment rate lower. But moderation in hourly earnings and steep declines in oil and other commodity prices suggest that, even if the economy operates a bit further beyond its long-run potential than anticipated at the last meeting, any increase in pressures on prices that might develop is likely to be quite limited for a while. Such a shallow upturn would probably offer the Committee sufficient leeway to react in a timely manner at a later date should evidence begin to emerge that a sustained upward movement in inflation might be coming. In addition, changes in financial conditions since the last meeting, on balance, do not point unambiguously to either greater stimulus or greater restraint on spending. Yield spreads show mixed movements over the intermeeting period. And while many longer-term nominal interest rates are down somewhat, rates on indexed securities are unchanged, suggesting that at least a portion of that decline owes to decreases in inflation expectations rather than in the real cost of credit.

While widespread easing of monetary policy in Europe and Asia should help to bolster demand, that easing was triggered in part by weaker economic prospects, at least in Europe. In Latin America, Brazilian problems have made the situation, if anything, dicier over recent weeks. The Greenbook forecast sees flat short-term interest rates here in the United States as consistent with moderate growth and only a limited uptick in inflation, attributable mainly to the projected turnaround in energy prices.

Against this background, and with financial markets even less liquid and more volatile than usual ahead of this year-end, the Committee may wish to keep policy unchanged at this meeting. There are, to be sure, substantial risks on both sides of the moderate growth and low inflation outcome, which the Committee will need to weigh as it considers the tilt in the directive and as it monitors incoming information over coming months.

On the side of a need to be especially alert to having to ease policy, there are still ample reasons to worry about the same small-probability, high-cost events that occupied the Committee's discussion in November. As Karen noted, the ability of Brazil to maintain its exchange rate regime has, if anything, become more problematic. While the passage of time and slow erosion of confidence in that country's policies undoubtedly have allowed counterparties and interested bystanders to take anticipatory protective actions, serious contagion from a loss of confidence in Brazil is still a distinct possibility. In domestic financial markets, the backup in risk and liquidity premiums over the second half of the intermeeting period highlights the continuing heightened sensitivity of these markets to shifts in sentiment. Greater resiliency may develop after year-end, when participants should feel more willing to open their books to taking on risks. Nonetheless, markets are likely to remain vulnerable and increased caution by lenders would be a natural reaction to the slower growth in income and lower profits expected in most forecasts.

Another source of downside risk is the potential for inflation--or more precisely, inflation expectations--to drop further, perhaps inappropriately raising real interest rates. But making that determination depends importantly on the source of the downward surprise in prices. Lower inflation that resulted from unexpected increases in productivity would be associated with higher equilibrium real interest rates because wealth would be higher and incentives for capital spending stronger. Easing policy under those conditions as inflation fell would risk greater price pressures down the road. Even declines in inflation from decreases in the price of oil and other imported commodities require careful judgment about whether real rates shouldn't be allowed to rise. Such price declines can bolster real incomes and spending, especially if they are not the result of an appreciation of the dollar. But inflation surprises from other sources--decreases in inflation expectations not associated with these factors or unexpectedly weak wage growth--could require the Committee to reduce the nominal funds rate to avoid undesirable increases in real interest rates.

Finally, financial market participants and many Wall Street economists apparently see the risks to growth and inflation as tilted to the downside, in that they have built further Federal Reserve easing into the yield curve and into their economic forecasts. Weakness in a number of the economists' projections comes from another potential source of shortfall in demand--a squeeze on profits. In these forecasts, persistently weak profits lower equity prices, impinging on consumption; and low profits, together with developing capacity overhangs, depress business investment.

But the risks are not all to one side. Aggregate demand has been strong, and financial conditions now may be no tighter--and might even be a little easier--than those of last summer and before. And presumably these are the conditions that have contributed to the recent robust economic growth, given the lags. Investors in bond markets have come to discriminate more carefully among borrowers, but on average yields haven't changed much, with increases for below-investment grade credits balanced by decreases for many better credits. As a consequence of policy easing, the costs of short-term credit to most businesses appear to have decreased despite higher spreads. For households, mortgage rates, which are tied closely to Treasury yields, have fallen appreciably. In foreign exchange markets, the dollar is lower than it was six months ago, potentially lessening some of the restraining effects of foreign competition. And not only has the stock market recovered previous peaks, but its resilience in the face of earnings warnings suggests upside potential for equity prices, as Mike noted. To be sure, current financial conditions may not be so accommodative as to keep real growth at 3½ percent. After all, it took continued outsized increases in equity prices over a number of years to produce this result. Instead, the danger may be that these financial conditions will slow growth only to the rate of increase in potential, preserving the current tautness in labor markets. As compared with the staff forecast, this would raise the odds on the emergence of greater price pressures when recovering economies abroad foster a turnaround in resource prices and a weakening dollar.

Interpreting the rapid growth of money may also help to assess the degree of risk that policy may be too accommodative to contain inflationary pressures.

Broad money growth, which has been strong all year, accelerated in the fourth quarter. Growth in M2 far exceeds the likely rate of increase of nominal GDP, and the resulting decline in velocity is much larger than can be explained with standard money demand models. This suggests a lack of stability in the underlying demand for money--one of the necessary conditions for money to be a reliable indicator. Indeed, some of the very recent strength in money seems to owe to greater desires by households for safe and liquid assets, itself symptomatic of problems in financial markets that would damp aggregate demand. Such an outward shift in the demand for money would indicate a need for a greater supply of money to support any given level of spending. These sorts of considerations would argue against a close linking of money growth and current or future spending or inflation.

Yet, in a very broad and imprecise sense, rapid money growth through this year may have been indicative that financial conditions at least were supportive of continued strength in aggregate demand. Positive surprises in money growth have been associated with positive surprises in spending, even if the numerical relationship between them has not been close. Moreover, some of the overage in money growth relative to the standard models this year may reflect household responses to rising levels of wealth and lower long-term interest rates--both important stimulants to spending. Finally, even the implications of the surge in M2 and M3 growth late this year might not have been entirely negative for the future path of spending. It did suggest the willingness and capacity of a well-capitalized banking system to absorb flows of funds diverted from markets, cushioning the potential impact of financial market disruptions on economic activity.

The staff, again, is projecting a substantial slowing in money growth over the months ahead. This forecast is predicated on the decelerating path of spending in the Greenbook and on some reversal of the flight to liquidity and safety of late summer and early fall. M2 growth has moderated in November and, on a partially projected basis, in December as well. If this slowing falters--if money growth remains very rapid--it may connote stronger than expected spending, but it will be important to examine closely the reasons for the overshoot.

Whatever your decision on the symmetries or asymmetries of the policy stance in the operating paragraph of the directive, the Bluebook on pages 13 and 14 presented three alternatives for the associated language. The first alternative is the existing language; the second is the alternative presented in November; and the third is a modification of that alternative incorporating the suggestions members made in November. We offered alternative two again because over the intermeeting period one of you indicated a desire to consider retaining the separate sentence on intermeeting moves in order to keep it conceptually distinct from the likely path of policy over the intermediate run. Also, in your discussion of what is now alternative three, several of you, including Governor

Kelley, President Broaddus and others, were of the view that the directive should only reference the intermeeting period and not include the reference to "in coming months." That remains an open issue.

We have also included alternatives for the wording of the sentence on the prospective growth of the monetary aggregates, responding to the discussion initiated by President Poole at the last meeting. That language already had a degree of flexibility, since it had been the Committee's practice to adapt it to fit the staff's forecast for money over coming months. And, in fact, it has changed several times this year. We can continue to offer alternative wording in the Bluebook for money growth expectations, as we have done for this meeting. The Committee might have different projections than the staff and, even if it didn't, it might want the opportunity to describe the staff forecast in different words than we suggest.

Another option would be to drop that sentence altogether from the operating paragraph--a suggestion made by President Guynn in September. The sentence has evolved over time from one that included specific numerical ranges for growth, whose violation could trigger a policy response, to the current vague expectation. That evolution has paralleled the Committee's de-emphasis of money in its policy deliberations. The Committee now makes no attempt to tie its annual ranges for money to expected or desired economic performance over the year, and the growth of money relative to its ranges plays no special role in policy decisions, as you have repeatedly informed the Congress. As a result, the Congress has displayed no interest in using the behavior of money to guide its assessment of the conduct of policy. Consequently, while you are cleaning up directive language, you might want to consider deleting this sentence. An earlier paragraph in the directive would continue to report the Committee's long-run ranges, consistent with the requirements of the Federal Reserve Act.

CHAIRMAN GREENSPAN. Incidentally, Don, when are we scheduling the next senior loan officer survey?

MR. KOHN. It will be before the February meeting. We will do the survey in the middle of January with the results coming in during the week before the February meeting. Preliminary results are usually in the Greenbook and the final results in the Greenbook Supplement. So you will have the results on the Friday before your February meeting.

CHAIRMAN GREENSPAN. Other questions for Don? If not, I will start off with some comments on developments relating to policy. I think all of you commented on the continued momentum in the economy. Even the labor market data, which appeared to be weak or at least potentially weak at the time of our November meeting, now seem to have stabilized. While the gap between the household employment figures and the payroll numbers, which has created a crucial issue in labor market evaluations, has not yet closed, it has narrowed as a consequence of a very large increase in estimated household employment in the latest survey. You also may recall that the statistical series that includes the number of unemployed plus those not in the labor force who would like to have a job seemed to have flattened during most of 1998, but it tilted down again in the most recent data. So, we see in effect a reversion to what existed earlier this year, not only with respect to a number of financial variables, as Don Kohn mentioned, but also with respect to many of the characteristics of the labor market.

What has not changed in any material way is the seeming lack of pricing power in the economy. I see virtually nothing that suggests upward pressure on prices despite the ongoing weakness in profit margins as indicated by available data for the fourth quarter. We see in the latest estimates of S&P 500 earnings per share that the trend finally has turned negative for the fourth quarter. Sales for the S&P 500 firms presumably have not gone down in nominal terms, but profit margins continue to decline. In the manufacturing sector, the data show a continuation of rather strong productivity gains and further declines in unit labor costs, but they also show a decline in margins, though mainly as a consequence of downward pressure on prices. So, what we are observing is a remarkable and, in fact, almost surely unforecastable economy that is expanding at a fairly rapid pace. We also see labor markets that, if anything, are growing marginally tighter, little evidence of wage acceleration, and no evidence of price acceleration. I assume that some of you believe that this can go on for a considerable period of time. I cannot believe it, but then again I said that six months ago. [Laughter] I guess we should enjoy it while it lasts.

As a number of you have indicated, the risks on both sides have widened. To a very substantial extent in my view, the risks probably reflect the extraordinary behavior of the equity markets over the last several years. The dramatic decline in the saving rate, which arithmetically is a very big factor in the continued growth of personal consumption expenditures and hence in final demand, seems to be attributable almost entirely in the last two or three years to capital gains increases not only in the equity markets but, as I will explain shortly, in housing as well.

If we disaggregate the household sector, we end up with a decline of a couple percentage points in the saving rate as a result of the wealth effect and another percentage point or so as a consequence of higher capital gains taxes. As I recall, the latter currently are running a little more than $70 billion per year according to our estimates. Their rise since 1993 has been equivalent to 1 percent of the current level of disposable income. In other words, the capital gains tax accounts for a decline of about 1 percentage point in the saving rate. Another percentage point or so can be attributed to significantly flattened requirements for contributions to defined benefit pension funds because the equity holdings in such funds have appreciated substantially. If these employee contributions had remained about the same as they were in 1993 in relation to income and had gone up with the rise in income, that would have added about 1 percentage point to the saving rate. So these factors taken together account for most of the 5 percentage point decline in the saving rate in recent years.

Superimposed on all of that is the very difficult problem of estimating the effects on the saving rate of developments in housing and in the process avoiding potential double counting. There has been a dramatic increase in sales of existing homes. Since the prices of homes have been rising substantially with very few periods of stabilization or decline, the moving average of price increases over the typical holding period for a home, which is about eight or nine years, has been positive for an appreciable period of time. As a consequence, realized gains associated with the sales of homes have been significant. The increase in mortgage debt that one can attribute to existing home sales may be derived by taking the net change in mortgage debt on single-family homes and subtracting from it the debt that one would anticipate if there were no turnover of existing homes--that is, new debt taken out on new home sales less scheduled amortization on existing mortgage debt. The net of those two subtracted from the total outstanding debt is a reasonably good estimate of the increase in debt on existing homes. That number looks remarkably close to independent estimates of capital gains on the sale of homes. The assumption here is that that money is extracted from the home market, which of course it is. Obviously, part of mortgage debt is in the form of home equity loans, but the major part occurs as a consequence of the turnover from sales. The seller of a home that has appreciated in value gets back not only the down payment and amortization payments on the home but the realized capital gain. The latter is largely reflected in the higher mortgage debt, which the buyer takes out on the home relative to what the seller writes down. As a consequence, the aggregate amount of realized capital gains in housing and, in a rough sense, the amount of net debt on existing homes have been going up commensurately with the dramatic rise in sales of existing homes.

Theoretically, one can say that if the cash received by the seller is unencumbered, which of course it is, there is no reason why it will not be used to make purchases. The economics literature is consistent with the view that consumer spending and cash flows move hand in hand. More specifically, evidence based on econometric analysis suggests that about half of the funds acquired from windfall cash flows such as realized capital gains are spent. So realized capital gains on homes, even if financed through an increase in mortgage debt, will have an influence on personal consumption expenditures.

The trouble, unfortunately, is that the stock market and existing home sales are not uncorrelated. This makes it difficult to form a judgment as to whether what we think is the stock equity wealth effect is really in part the housing wealth effect. The reason this is important is that when the stock market declines, if ever, it does not necessarily follow that the same pattern will occur in existing home sales. As a consequence, unless we are able to disaggregate the wealth effects that are involved--and we are going to do some of that analysis to get a sense of those effects--the forecast of final domestic demand in the next year or two will be a very complex undertaking.

The conclusion I draw from all of this is that in addition to income, capital gains have become a very important factor in the overall behavior of final demand. Obviously, the important issue here is how we view the stock market outlook. While it is true that we are seeing earnings expectations fall in the very short run and it is certainly the case that security analysts have dramatically reduced their earnings expectations for the year 1998, they have not decreased their earnings expectations for the longer run. As a consequence, if their earnings per share numbers for five years out have not changed materially, the lowering of estimates for the near term implies higher expected growth rates of five-year earnings. This effectively explains how the stock market can rise with earnings expectations falling. The answer is: They are not falling; it's long-term earnings that are relevant for stock prices, not short-term earnings.

I don't know how all of this is going to turn out. The presumption that stock market prices can continue to grow 20 percent a year seems absurd, as I think some of you said, but so do a lot of other things. The presumption that the market is going to level out is probably the least unsupportable position and that presumption is consistent with the Greenbook's predicted impact of the market on personal consumption expenditures. There also has to be a non-negligible probability that the market could go down very substantially. I'm not entirely certain how we would respond to that. However, I do know that the presumption we have discussed in the last year or so that we can effectively manage a bubble is probably based on a lack of humility. As I've said before, a bubble is perceivable only in retrospect.

I think uncertainties on the financial side are going to be increasingly difficult for us to factor into our policy deliberations over the next year. The reason is that, as Cathy Minehan said earlier today, the probabilities have risen quite substantially on both sides. What we observe in today's economy is an extraordinary momentum coming out of the 1993 and more importantly the 1995 period. The very substantial expansion of the asset side of balance sheets obviously is affecting capital expenditures as well as personal consumption expenditures.

If the economy's performance in 1999 essentially replicates the Greenbook outlook, we will be lucky and fortunate indeed. Knowing that this transcript will be read five years from now, I suspect that comment will be perceived to be very precocious. [Laughter]

The bottom line on policy clearly is, as far as I can see--and indeed as most of you have indicated--that we should stay where we are because, as Mike Kelley said, it is not obvious in what direction the next policy move should be. I think we moved very effectively during the fall. I believe we broke what was a dangerously eroding financial situation. In my view, we now are in the position, having completed that episode, where our policy is back to balance and we should be looking to both the upside and the downside in judging the potential direction of our next move. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I interpret that, as I'm sure you intended, as a recommendation for "B" symmetric, which I heartily endorse. As far as luck goes, I am reminded of the immortal words of Lefty Grove: "It is better to be lucky than good." In that year, he won 31 and lost 6.

CHAIRMAN GREENSPAN. If he had been right-handed, he would have lost eight. [Laughter] President Parry.

MR. PARRY. Mr. Chairman, I believe our easing of policy and the associated stock market rebound have significantly reduced the chance of recession or a major slowdown over the next year or so, and for now I think we should leave the funds rate at 4¾ percent. Although I believe the upside risks to growth, at least in terms of the rate of growth forecast in the Greenbook, are greater than those to the downside, I can support a symmetric directive for this meeting. Do you want comments on the options?

CHAIRMAN GREENSPAN. I should have mentioned that. Why don't we conclude this policy discussion and afterwards go back to the directive wording issue instead of taking that up now.

MR. PARRY. Okay. That's all I have for now.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. I, too, support an unchanged federal funds rate. But I want to talk about looking further out into the future than just the current situation. Mr. Chairman, you emphasized what I regard as indeed the key feature of our economic environment, the lack of any pricing power. I think that comes from what are now, fortunately, very, very deeply embedded views about price stability or continuing low inflation. Back in the 1970s when firms would raise prices, other firms would use that as a good excuse to raise their prices also. Now when firms raise prices, other firms do not follow, and the original price increase gets rolled back. And understanding that process, firms don't try it in the first place. So we have a very deeply embedded environment of low inflation. I view that as a great strength in our situation.

But I ask myself this question: What would we expect to observe from a dose of monetary stimulus in an environment with entrenched expectations of low inflation? In other words, the stimulus is not going to flow through, at least in the near term, to goods prices but it is going to flow through to something else. What I would expect to see is that it would flow through to some combination of asset prices and output if it cannot flow through to goods prices.

I would note that M2 growth at roughly 9 percent is high but not explosive. We are not dealing with an explosive situation in money growth, but it is high. So, it seems to me that what we have observed is fairly consistent with the picture that I am drawing, that the dose of money growth has been flowing through to higher-than-expected output. We certainly see it in consumption; we see it in investment. The economy as a whole is operating at a high level. We have seen it flow through to many asset prices, though not all. This is consistent with the stock market story. I'm talking now not about recent weeks, but in a perspective of about the last 12 to 18 months and what has been going on with the high money growth. Certainly the picture with bond prices is consistent. Interest rates have gone down a lot; bond prices have gone up in the last 18 months. We have talked about house prices and real estate prices more generally. Here again, the rate of increase is not explosive, but there is no question that it is a change from what we had earlier in the 1990s. Some of this I think is a consistent story that money creation has been showing up in house prices and apparently even in agricultural land prices. Despite the weakness in current farm goods prices, agricultural land prices are not plummeting.

There are important exceptions to this hypothesis that I am offering. Until the last few months, the dollar has tended to be strong rather than weak. We have not seen increases in prices of foreign assets relative to the dollar. Certainly oil and other commodity prices have gone down sharply. Oil is an important asset that can be held in the ground; it does not have to be produced. But I am persuaded that the money growth that we have seen is showing up more or less as we would expect in the economy and that it explains a great deal of what we see in the current situation.

Ned Gramlich earlier talked about the difficulties of explaining the money growth that we've seen. I would like to present an analogy here. Suppose we saw a jump, let's say, in the ECI. If we could explain that jump as a consequence of some anomalies in the data or faulty seasonal adjustment or something like that, we might feel comfortable with the jump. But if we could not explain that jump, I think all of us around this table would assume that, lo and behold, we were finally starting to see the results of the labor market pressures in that number. So, the fact that we cannot explain in detail where this money growth is coming from or where it is showing up is not a source of comfort to me but a source of concern.

If it were not for the fact that a tightening today would be a very large shock to the market, given our recent easing moves, I think there would be a case for tightening now because we are working through the credit market disturbance. The bond market is functioning normally again; the number of new issues is back more or less where it was. But I do believe that it is very important that monetary policy be consistent and predictable over time. Therefore, I would not favor a move today because it would be regarded as very, very peculiar in the light of what we have done recently and in the light of the expectations that we have established.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. I can agree with "no change" today. Even though I disagreed with the funds rate reduction in November, I would not reverse it as of today. I don't know what is going to happen in the future because of the potential for external shocks from Brazil or Russia or elsewhere that will influence the way the domestic and international financial markets function. But holding that aside, I think domestic considerations are going to require at some point that we start to raise the level of the overnight interbank nominal rate in order to slow the growth of money and credit.

On the issue of pricing in goods and services markets, the area I would watch very carefully is that 13 or 14 percent of the economy we call the health care sector. Significant upward pressures are already emerging in that sector. We also see prices being raised, at least in our region of the country, in a broad range of leisure goods industries including recreation, travel, tourism, entertainment, and restaurants. So, I think that we are seeing the brown spots.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. Mr. Chairman, I concur with the "no change" and a symmetric directive. I think the risks are on both sides, but they are of a somewhat different nature. The upside risks would probably emerge gradually and not surprise us by their virulence. The downside risks, I think, are likely to be reflected in big changes if they materialize, although the probability may be smaller.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Mr. Chairman, I, too, endorse your view of "B" symmetric. I also agree with Governor Rivlin that the risks are likely to be somewhat different. The downside risks, as they have over the last year, seem to have a low probability of developing but are likely to be highly visible if they do. Actually, I do slightly disagree with her. I think the upside risks are likely to sneak up on us. While I don't think we will necessarily be behind the curve, I do think it will be important to be very vigilant.

MS. RIVLIN. They won't sneak up on Jerry Jordan. He already has them factored in. [Laughter]

MR. FERGUSON. I think we are, as you indicated, back to a posture very similar to where we were earlier this year.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I also favor "no change" with a symmetric directive today. I think the case for that has been made very well around the table. As I was reflecting during the break, I was struck by the number of people today who in the earlier go-around identified and quantified the upside risks, certainly to a greater degree than was the case last time. I would associate myself with those who have encouraged us to be as ready to move on the upside to tighten policy as we were very recently to ease on the downside. I think such behavior would reinforce and preserve our credibility for the next rainy day. But I am very supportive of "no change" and a symmetric directive today.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support "B" symmetric without any agonizing! [Laughter]

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I support "B" symmetric with a little bit of agony. [Laughter] I agree with your description of the risks. However, I do want to emphasize, as have others, that we have made progress against inflation but that our forecast for 1999 shows inflation edging up a little. We all know it's because of energy price increases, but I think it does require careful monitoring since we do not want to give up the underlying gains that we have made against inflation.

I also want to make a brief comment about your description of the earnings forecasts by Wall Street analysts, with the short-term earnings forecasts coming down but the long-term forecasts staying where they were before. It reminds me of my years when I was in private industry and looked at many, many business plans, as I am sure you did as well. The head of a business would often come in and say, "Earnings this first year are going to be down, but wait until years two, three, four, and five. They are going to go right up!" We called this the hockey stick approach because we saw it so frequently. So, I would be very skeptical about the forecasts that the Wall Street analysts are making about long-term profits.

CHAIRMAN GREENSPAN. I tried not to convey a view that was other than that. President Stern.

MR. STERN. I, too, support "B" symmetric.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Mr. Chairman, I support your recommendation for no change in the funds rate target and to retain the symmetric posture for the policy directive. I believe it is sometimes useful to think about monetary policy in terms of the desired path for the growth of output instead of the desired path for the funds rate. The path of output for 1999 projected in the Greenbook seems about ideal to me. It shows a slowdown to below-trend growth, which I think is very important, and some unwinding of the exceptional tightness now in labor markets but leaving plenty of room, given the potential downside discontinuities in the forecast. This means that no policy action is warranted today and none would be warranted when and if the economy slows to the projected path. Looking beyond that, if we do not get a realization of those downward discontinuities, I am struck by how brief the period of below-trend growth is in the forecast and how modest the shortfall is relative to potential growth. To me that means, after we get a better sense that we have avoided these downward discontinuities, that we are going to have to be very vigilant against potential upside risks to inflation going forward.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I also agree with your recommendation of "B" symmetric. I agonized before, so I'm not going to do it now.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. I support "B" symmetric. I would just like to make one point about something that Alice Rivlin said about the short lags, which I tend to agree with. The implication is, I believe, that it gives us a little time. We can wait until we see some brown spots before we have to do anything. We don't have to eat the banana when it's still green! [Laughter]

MS. MINEHAN. The agony of bananas!

CHAIRMAN GREENSPAN. Can you top that, Tom Hoenig?

MR. HOENIG. I am speechless! But I'm going to say a couple of things anyway. First, I support your recommendation completely. Without getting into bananas or agonizing, I would caution us about how we look at the need for future policy actions. Here I associate myself a little with Bill Poole. I think we need to look at the actions we take in terms of the risks, especially the risks to the domestic economy, and the systematic forces that are in play that lead to the upside risks: our policy easings, the rapid monetary growth, strong domestic demand, and robust income growth. I think those factors do give us pronounced upside risks.

On the other side, the downside risks, as Governor Rivlin said, are risks of shocks, which are impossible to forecast. I'd suggest that we consider not holding off too long on the unwinding of our recent easing actions as we worry about the downside risks from shocks that might occur but also might not occur. So I want to be thinking about unwinding our earlier actions unless some real shocks emerge.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I agree with your recommendation.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. I agree with your recommendation.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I agree with your recommendation, Mr. Chairman, not with agony--that would be too strong a term--but with at least some sense of unease. What I especially agree with in your recommendation is your statement that we are now back at the point of looking at the risks on both sides of the equation. My feeling is that they are now probably skewed to the upside. I agree with the comments that Larry Meyer made and Bill Poole as well. I am comfortable with a symmetric directive at this meeting but had you recommended an asymmetric directive toward tightening, I would have been perfectly happy with that as well.

CHAIRMAN GREENSPAN. Okay. Before we move to an official vote, let us now go back to the issue of the directive language. Remember that there are two issues to be resolved, presumably finally, after our previous discussions. One involves the question of the deletion of the phrase "in coming months," which is the basic distinction between option 2 and option 3. The other is the possible deletion of the sentence on the growth of the money supply at the very end of the directive. As I understand it, on the basis of our previous discussions, there is strong support for option 3 at this point. Some members of the Committee have focused on the question of deleting the language in the middle of option 3 regarding the months ahead, I believe, and some have raised a question about deleting the money supply language. It would be helpful if we went around the table fairly quickly to get a statement from each of you on those issues. It may be that if we get a significant modal value on these, we can finally bring this discussion to a conclusion.

MR. BOEHNE. May I ask one question, Mr. Chairman? I was one who, just for language purposes, wanted to drop the sentence: "Any potential changes in the federal funds rate...." Some expressed a concern that one of the subtleties of that wording related to your authority to act on the Committee's behalf between meetings. One view was that dropping that sentence somehow might be interpreted or perceived as compromising your authority between meetings. My question to you is: Do you believe that the deletion of that sentence in any way creates a perception of compromising your authority?

CHAIRMAN GREENSPAN. I do not, mainly because the members around this table said it did not. And that is the ultimate determination.

MR. BOEHNE. Thank you.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I like option 3. I agree with the language in the middle sentence that includes both the coming months and the intermeeting period. I would have no problem with deleting the sentence on the money supply but I certainly would not get into an argument if we left it in.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I think I would prefer option 3, although I don't feel strongly about most of the differences. I would delete the sentence Ed Boehne talked about on potential changes in the funds rate because I view it as more confusing than helpful. I do feel rather strongly about taking out the "in coming months" phrase, which appears in both versions, options 2 and 3. I think it is irrelevant because we always review our stance of policy at every meeting. "In coming months" has no meaning and could easily be harmful in the sense that it might appear to commit us to a direction for policy over whatever period some people might interpret as "in coming months." And our views on that could change quite radically.

On the final sentence on the monetary aggregates, I have no strong feeling. I don't think it is doing any harm and the day may well come, perhaps soon, when we would be glad to have it in there. So, I would leave it alone.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, I would prefer option 3 but, like Governor Kelley, I have a rather strong preference for taking out that phrase "in coming months." This is an operating paragraph that is supposed to focus on our plans for the operating instrument over the operating period, which is the period until the next meeting. As a matter of logic and clarity, that phrase just seems to clutter things up and could cause some unnecessary confusion.

With regard to the money sentence, I have a preference for leaving it in. It does not refer to an operating instrument. However, this is monetary policy, and I would like to see a reference to money in a statement about monetary policy.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. I support option 3 and taking out the "in coming months" for the same reasons that Governor Kelley and President Broaddus have stated. I have a slight preference for getting rid of the monetary aggregates sentence, but I don't feel strongly about it.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I, too, favor option 3. I feel very strongly about taking out "in coming months" for the reasons that Governor Kelley and President Broaddus stated earlier. As for the M2 and M3 sentence, it could go or stay; I don't have a strong opinion. But since monetary trends do seem to provide us with some information, at least at the present time, on balance I come down in favor of keeping it in.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. I would delete the sentence in question in option 2, thereby going with option 3. I would actually prefer to leave in the phrase "in coming months" in option 3. It goes to the question of what we mean by symmetry and asymmetry. Does it refer to the intermeeting period or is it a statement about the balance of risks that we see that might influence when the next move might occur over some reasonable forecast horizon? I like the broader context. I think that is what symmetry or asymmetry means. Most importantly, it is not positioning ourselves for either the intermeeting period or the next move but to provide some broader concept of how we see the balance of risks.

With respect to the last sentence, I would prefer to delete it because I don't think it has to do specifically with the directive itself. It could go elsewhere in any discussion of the underlying forecast, but I don't think it belongs here.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Actually, given that Larry Meyer was so convincing, I will stand behind him: Option 3; retain "in coming months;" and drop the last sentence.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I prefer option 3. I think the last sentence on the monetary aggregates should be retained. I don't feel that strongly about the debate over "in coming months" versus simply "during the intermeeting period." On balance, I'd keep the sentence the way it is and leave it in.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. I will be a purist on this, Mr. Chairman. Since this is a directive, I think the phrase "in coming months" should come out and the last sentence should come out too. I don't feel as strongly about the last sentence as I do about the phrase "in coming months."

CHAIRMAN GREENSPAN. Are you for option 3?

MR. MOSKOW. Yes.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. In option 3 I would take out "in coming months" for the same reason that President Moskow indicated. I also have a preference for removing the last sentence.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. I have a slight preference for option 2, but the consensus seems to be going toward option 3. So, I will go with that since it does what I think we need to do. With respect to the issue of "in coming months," I would retain it for the reasons that Governor Meyer indicated. I would also retain the last sentence for much the same reason. The entire tone seems to be expectations over a foreseeable period having to do with the risks and also with M2 and M3 growth.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I am for option 3. I would drop "in coming months" for the same reasons and with the same degree of conviction that Governor Kelley expressed. I am practically indifferent about the last sentence. On balance, I would probably keep it in.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, atypically for me, I am fairly relaxed about the whole thing. [Laughter] I have a marginal preference for taking out the words "in coming months." Perhaps inconsistent with that, I would leave the money sentence in on the theory that to spend the next year of our lives having knock-down, drag-out battles with the monetarists of the world is not worth the struggle.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I would go for option 3. I would take out "in coming months" because I view this as the operating directive that applies until the next meeting. I believe that a sense of the longer-run perspective of the Committee can be and is given in the minutes that are released at the same time as the directive. I feel strongly that the last sentence referring to M2 and M3 should come out because I believe that in the interest of accuracy it should reflect what the role of money is in the Committee's deliberations. I also believe that it could serve as a useful policy device at some point. If and when money is regarded as being more important in our deliberations, it can be put back in; and markets are going to notice if we put it back in. If there is a change in our view on this matter, then it seems to me we would want a way to convey that. And putting it back in would be a clear way to convey it.

CHAIRMAN GREENSPAN. So you are taking it out?

MR. POOLE. I would take it out now because in the interest of accuracy it does not belong there.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I'd go with option 3 and remove "in coming months" for the reasons Governor Kelley gave. I'd keep the last sentence for the reasons Al Broaddus gave.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. I, too, favor option 3 and would delete the last sentence on the aggregates. I would leave "in coming months" in for the reason Governor Meyer articulated. I would delete the last sentence for the reasons that President Poole referred to. I hope that helps in reaching a consensus. [Laughter]

MS. MINEHAN. We need a debate between Governors Meyer and Kelley.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I prefer option 3 and I'd delete the reference to "in coming months." My first preference would be to keep the sentence on money if it were read and interpreted by everybody as a true proviso clause: If, for example, it meant that if money growth does not slow down as currently indicated in that sentence, we would change something. But since we do not use the sentence that way, I think it has to come out.

CHAIRMAN GREENSPAN. That covers all the speakers. If you can give the Secretariat just a minute to assess where the Committee comes out on the wording-- [Laughter]

MR. MEYER. The decision is so clear from that discussion!

MR. KOHN. We have only been discussing this for a year now. I went to New Zealand hoping that this issue would be settled before I returned! [Laughter] Dave Lindsey let me down.

VICE CHAIRMAN MCDONOUGH. You are going to have to write the minutes summarizing this discussion.

MR. KOHN. We might just say: "The Committee then turned to the directive language. At the end of the discussion...."

CHAIRMAN GREENSPAN. The vote is unanimous in favor of option 3. There are small majorities in favor of eliminating the "months ahead" reference and the "money supply" sentence, but the votes are not overwhelming. The three of us who were tabulating the preferences during the discussion get the same results, so I assume that our count is accurate. Unless I hear an objection, we will use that wording in the current directive. Would you read the new wording with the policy the members have endorsed, namely "B" symmetric.

MR. BROADDUS. Mr. Chairman, could I raise a quick question? Are we going to return at some point to the question of when this would be released?

CHAIRMAN GREENSPAN. Yes.

MR. KOHN. It's the next item on the agenda.

MR. BERNARD. The wording is on page 14 of the Bluebook: "To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 4¾ percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
Governor Ferguson	Yes
Governor Gramlich	Yes
President Hoenig	Yes
President Jordan	Yes
Governor Kelley	Yes
Governor Meyer	Yes
President Minehan	Yes
President Poole	Yes
Governor Rivlin	Yes

CHAIRMAN GREENSPAN. We will now go back to the old issue of disclosure policy. A summary of our past discussions and positions on this issue and a proposed solution have been written out and I will proceed to read it.

The Committee has had two very productive discussions this year on disclosure issues other than the tilt language, at the June-July meeting and the September meeting. However, the Committee's views seem to have evolved mainly into two disparate positions, both of which have presented very cogent arguments in their favor. One group, a small majority of the 18 governors and presidents, supports: (1) releasing the operating paragraph of the directive, which includes the tilt, immediately after every FOMC meeting; (2) releasing a brief announcement immediately after those meetings in which either the policy stance or the tilt is changed; and (3) releasing the minutes of the meeting as soon as feasible after every FOMC meeting, presumably a couple of weeks earlier than now.

Another group, a sizable minority, advocates keeping the status quo in all these respects. That is, the operating paragraph would continue to be released along with the minutes after the next meeting, and immediate announcements would routinely be made only after policy changes.

Finally, two presidents would drop the tilt entirely from the operating paragraph.

My impression is that in general the Committee's views have become held with increasing conviction and have polarized into these two main groups. As Chairman of the Committee I would strongly urge that on a matter like this one, where any change will be irrevocable in practice, the FOMC should not adopt a reform based on a narrow favorable vote, with a sizable minority of the governors and presidents strongly opposed. A small shift in the voting balance toward status quo would not enable us to reverse policy any more than a death sentence is reversible after being carried out.

VICE CHAIRMAN MCDONOUGH. Wow!

CHAIRMAN GREENSPAN. Instead, I would propose a compromise solution, which we can try out on an experimental basis at least for the time being. That compromise, which I may say was crafted by Don Kohn in a Solomonesque insight, would be for the Committee to continue its current practice of releasing the operating paragraph and minutes after the next meeting but to expand the coverage of its immediate announcements to include those instances where, even when policy has been kept unchanged, the Committee wants to communicate to the public a major shift in its views about the balance of risks or the likely direction of future policy. This announcement would be reserved for situations in which the consensus of the Committee clearly has shifted significantly, though obviously not enough to change policy, and in which markets would be informed that our thinking has changed in order to avoid seriously misleading them. It would not apply every time the tilt was changed where these changes in the tilt encompass only small shifts in the center of gravity of Committee thinking or where in the context of incoming data the markets have already surmised the shift in Committee thinking.

The announcement itself would not necessarily reference the tilt but instead would concentrate on the change in the Committee's assessment of economic prospects.

For example, under the compromise we presumably would have made an immediate announcement after two FOMC meetings this year when we did not change policy. An immediate announcement after the late March meeting would have indicated that the Committee had seen a shift away from a situation in which prospective forces were roughly offsetting to one in which the risks of greater inflation seemed apparent. Such an announcement would have avoided some confusion over the intermeeting period as market participants attempted to interpret our remarks, and an unauthorized disclosure of the tilt occurred.

An immediate announcement after the August meeting would have conveyed the Committee's perception of a change in the risks from rising inflation to a more balanced outlook. In the event, as you recall, with your agreement I revealed the shift in a speech at Berkeley following our Jackson Hole discussion. It would have been better communicated, in my judgment, with a Fed statement. As was demonstrated after the last FOMC meeting, an announcement can be used to convey the message that the Committee has changed its assessment of risks, including a sense of the tilt, even without the release of the operating paragraph.

The compromise, which is suggested by Don Kohn and which I fully support, boils down to a commitment at times of a major shift in the Committee's sentiment to take advantage of the current disclosure policy in which the Committee has reserved the right to make an announcement in the absence of policy changes. When the FOMC announced its new disclosure procedures in February 1995, the statement said in part that it would "announce each change in the stance of monetary policy, including intermeeting changes, the day they are made. When no change is made at a meeting, the Committee will normally just announce when the meeting ended and that there are no further announcements. However, in some infrequent circumstances, the Committee might decide to issue a statement even when no policy action is taken."

With respect to the implementation of this particular change in policy that is being recommended, because the recommended compromise represents an implementation of the Committee's current policy with variations, assuming that an informal consensus of the Committee agrees with the idea, I do not think that a formal vote today would be needed. I should point out that should you concur with the compromise, it would not foreclose later shifts in procedures in either direction based on our experience with this approach. In fact, I suspect our experience might help us to reach a consensus.

Finally, news of this approach will get out when the minutes of this meeting are released in early February, and I could discuss it further in my February Humphrey-Hawkins testimony. If so, these procedures would be put in place by the March FOMC meeting.

I would be most interested in comments.

MR. GUYNN. Clarification, Mr. Chairman. I may not have listened carefully enough but I am not clear: Would this be a statement from the Committee and would the statement be reviewed by the Committee at the meeting after which it is to be released?

CHAIRMAN GREENSPAN. Yes. At the moment, we now discuss our position with respect to policy in terms of alternatives A, B, or C, and, secondly, with respect to tilt. When it appears appropriate, there would be a third element in the discussion, which would be a statement the Committee might wish to make. And that statement would be cleared and edited by the Committee.

MR. KOHN. That process, Mr. Chairman, would be approximately the same one followed when there are policy changes now. That is, you would read to the Committee a draft of the proposed statement and ask for their comments.

CHAIRMAN GREENSPAN. That is correct; that would be my intention. President Parry.

MR. PARRY. Mr. Chairman, I think the compromise proposal you have made makes some sense. To me it is a move in the right direction. As I'm sure you will recall, I have indicated in the past that I would like to see the directive included in the statement released immediately after each meeting. But there is no question that if we do that, we cannot go back if we find that we are not comfortable with that in practice. So to me at least, this is a step in a direction that I think many of us wish to go. As you indicated, if it looks as though we might want to go even further, we will have that alternative available at a later point. So I view this as a reasonable compromise and one that I certainly can live with.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Mr. Chairman, your proposal is a compromise that I can heartily endorse. Indeed, I think I would argue that it is better than either the status quo or at this point going to the immediate release of the operating paragraph. As you know, I have been an advocate of the immediate release of the operating paragraph in general and the decision on the tilt in particular. But I also agree with you that a change like this should not be made unless there is a stronger consensus than now exists.

It seems to me that what your proposal does is that it respects the views of the majority by affording an opportunity to make announcements about symmetry on those occasions when it would be most constructive. In that regard, this approach goes a long way toward fulfilling the objectives that I have. But it also respects the views of the minority by not making a formal change in the operational procedures that cannot be easily reversed.

And, as you also indicated, there is a chance to experiment. Let's see what happens. Let's see how useful in practice these announcements are, and let's also get a feel for the degree to which they affect the dynamics of our decisionmaking and consensus-building. The discussions we have had around this table over the last couple of meetings have given me a better appreciation of the potential costs as well as the likely benefits of an immediate release. Given the uncertainty about this balance, I think your compromise is a perfect solution.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I think the compromise makes a lot of sense as a way to try out a simple recitation of the reason why no policy change was made. I have long felt that no policy change is as much a decision as a change in policy is--that there is a policy content to whatever we do at all of our meetings. At times it could be very useful, as you have suggested, to release an explanatory statement. I think the experience we had with the short statement after our last meeting gave us an indication that this could be quite positive in terms of how the market reacts to what we are doing. In that case, the statement was made in the context of a policy change. Still, it provided a little explanation of it, and that gives us some insight into how a simple discussion of the understandings of the Committee beyond no policy change would be reacted to in the future. So to me it is very definitely a step well worth taking.

I also agree with your view that making a major move in what we say to the public about what we are doing without full consensus, without everybody buying in, could potentially be a real problem and that we could not go back.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, I certainly understand the dilemma we face and I agree that we need to have a strong consensus before we make a fundamental change. I suppose this is probably a good step, but I'm not quite as sure or confident of that as other people. I think there is some risk that it could cause confusion in the markets and for the public generally. I guess I'm thinking of a situation where there is no change in basic policy but where we change the tilt. As I understand it, sometimes we would announce it and sometimes we would not; I don't know what the criteria will be and I think there is going to be some head scratching out there about that. I can certainly support your suggestion. However, I think it would be very useful to have a formal commitment that a year from now we will revisit this issue and evaluate in some detail how it has worked. Then at that point we can decide whether it has been a plus or a minus and whether we should go forward or backwards.

CHAIRMAN GREENSPAN. I think that will be automatic.

MR. BROADDUS. Okay.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I think your suggestion is an excellent one. In preparation for this meeting I did go back and read the transcript of the discussion we had on this issue at the July meeting. It really was an excellent discussion, pointing out the different views that people had on this subject. Since I am one of those who were in the minority, with a strongly held view, I think this is an excellent next step to take. We can review it after a year and see what results we've had with it.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I will go along with this suggestion out of respect for the majority view that I know exists and also your effort to try to resolve the issue. But I do so with considerable trepidation. For one thing, I think it is going to put you particularly as well as the rest of the Committee in the position of having to make some very difficult judgments as to when we should make a statement and when we should not. More often than not, that is probably going to be a very close call. The second observation I would make is that once we start this, no statement immediately becomes a statement. Let us not kid ourselves about making a statement occasionally. We are going to be making a statement at every meeting, even those where we make no actual statement.

CHAIRMAN GREENSPAN. If that happens, this is a mistake. I do not envisage that as what this compromise is.

MR. KELLEY. I believe that the market will come to see our lack of a statement as indicating that there was essentially nothing going on at the meeting and that everything is just rolling along at wherever it was perceived to be before. And I think that is a statement. It will be an implied statement.

I also have considerable skepticism about whether we would have the ability to go back to the current status quo should that turn out to be desired. I think President Parry hit it on the nose when he said it was a step in the right direction. It is a step! [Laughter] It will clearly be difficult to go backwards should we subsequently, for whatever reason, desire to do so. But I will go along for the reasons stated.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. Mr. Chairman, I am quite strongly with the majority and I believe that more communication to the public is better than less. I view this as a step in the right direction. I would like to know how we nominate Don Kohn for the Nobel Peace Prize. [Laughter]

CHAIRMAN GREENSPAN. The war is not over yet! President Hoenig.

MR. HOENIG. Mr. Chairman, it is a good suggestion and I am in favor of it. I think we should learn from it and then decide if we need to do anything differently sometime in the future. But I'm very comfortable with it now.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Mr. Chairman, I support your suggestion. I think we have discovered that the markets tend to work better when there is more information as opposed to less. I think that the Committee can in fact draft the kinds of statements that are necessary and that this will be, as you observed, an important learning experience for us.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I believe this is a step in a good direction also and I have confidence in the Committee. Actually, maybe I have even more confidence in the Committee's counselor. In my misspent youth I was a student of the Old Testament. The wisest man in the Old Testament was not Solomon but an advisor of David called Ahithophel. The passage is "and the counsel that Ahithophel gave in those days was as if a man were to speak with God!" [Laughter]

SPEAKER(?). It will just go to his head.

MR. KOHN. There is a burning bush on the table.

CHAIRMAN GREENSPAN. I think he'd prefer the Peace Prize of the month! How can he improve on that? When you get to the top, you can't go any higher.

VICE CHAIRMAN MCDONOUGH. He can help us by proving that Governor Kelley is wrong.

CHAIRMAN GREENSPAN. That would be a good way.

MR. MCTEER. You do not have to sacrifice a baby in this process.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I support the proposal.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I believe Don Kohn deserves to be complimented, but I don't think I'd go as far as others have! [Laughter] I think it is a learning step. It is a good compromise. I hope that we all keep open minds and indeed do learn from it. At some appropriate time we can then weigh the evidence and decide what we want to do. It may indeed turn out to be a good step; it may not be a good step. But I think a learning step is a step in the right direction.

CHAIRMAN GREENSPAN. Do you want to speak again, Jack?

MR. GUYNN. Yes, please, if I may. Mr. Chairman, I support the compromise primarily because it represents more transparency and more information. I also want to identify with Al Broaddus's comments. This is not going to be without risk and agony, going back to our earlier discussion. I would hope that the small majority that favors the full step can continue to work with the rest of the Committee and that we can build a bigger majority over time as we gain experience with this. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support your recommendation.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I think the suggested approach is an excellent one. It gives us the opportunity to provide more information in a timely way when appropriate, and we can learn from that experience.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Yes, I also support the proposal.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. I support it. I would like to compliment some combination of you and Don Kohn. I believe Mike Kelley raised some good, sobering thoughts, but I think the way to deal with his concern is to use this new tilt announcement procedure only in rare circumstances. In my view that is how it should be done.

CHAIRMAN GREENSPAN. Okay, we will adopt that policy. It does not require a vote at this point. We can adjourn to lunch. The next meeting is February 2nd and 3rd.

END OF MEETING

APPENDIX

Charts used by Mr. Fisher in his presentation

3-Month Deposit Rates

July 1, 1998 - December 18, 1998

Current euro-deposit rate and rates implied by traded forward rate agreements

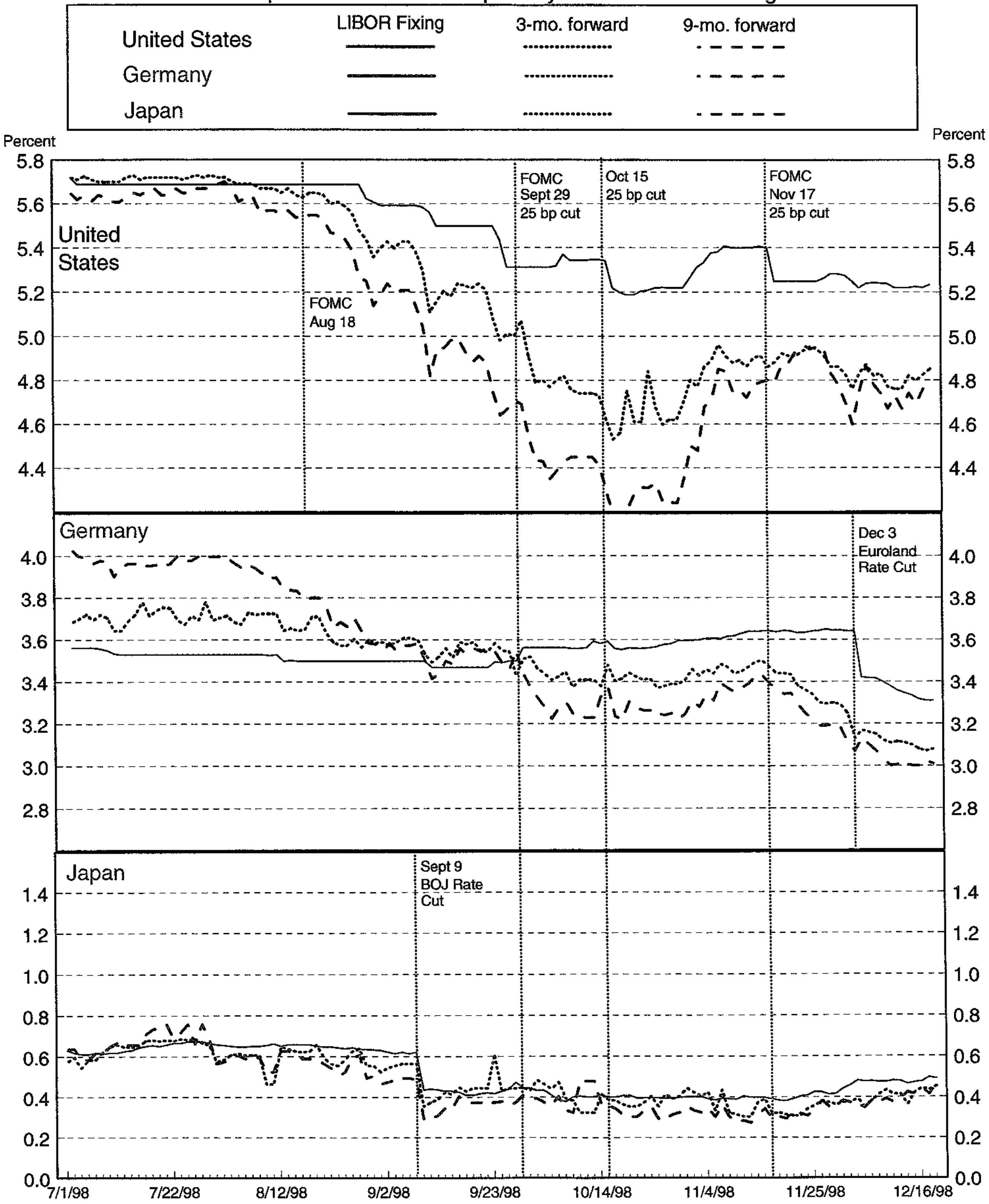
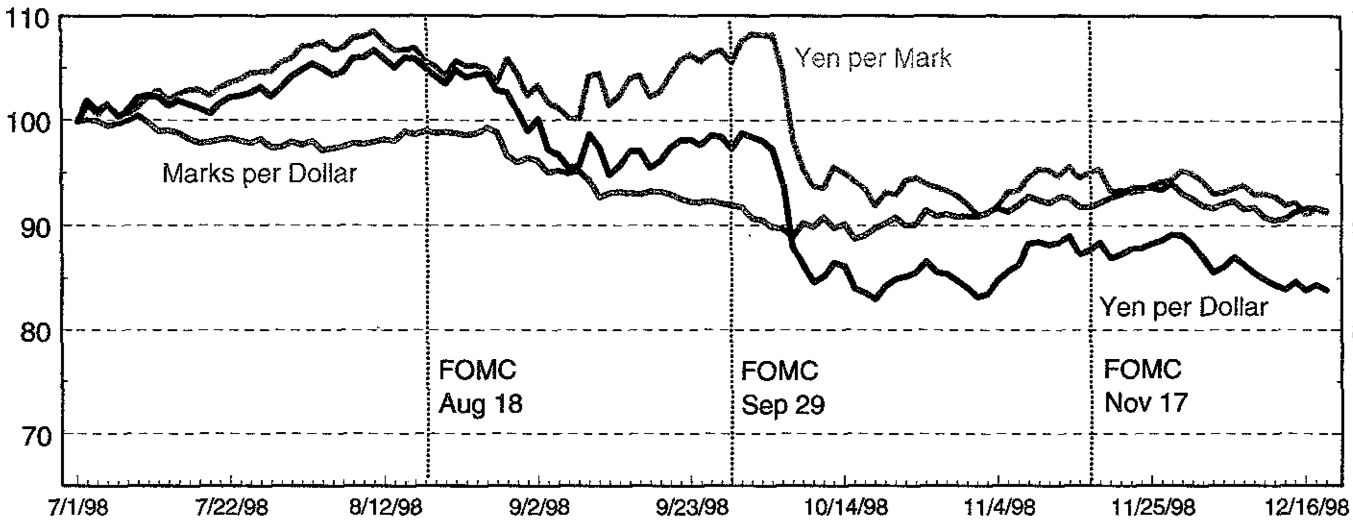
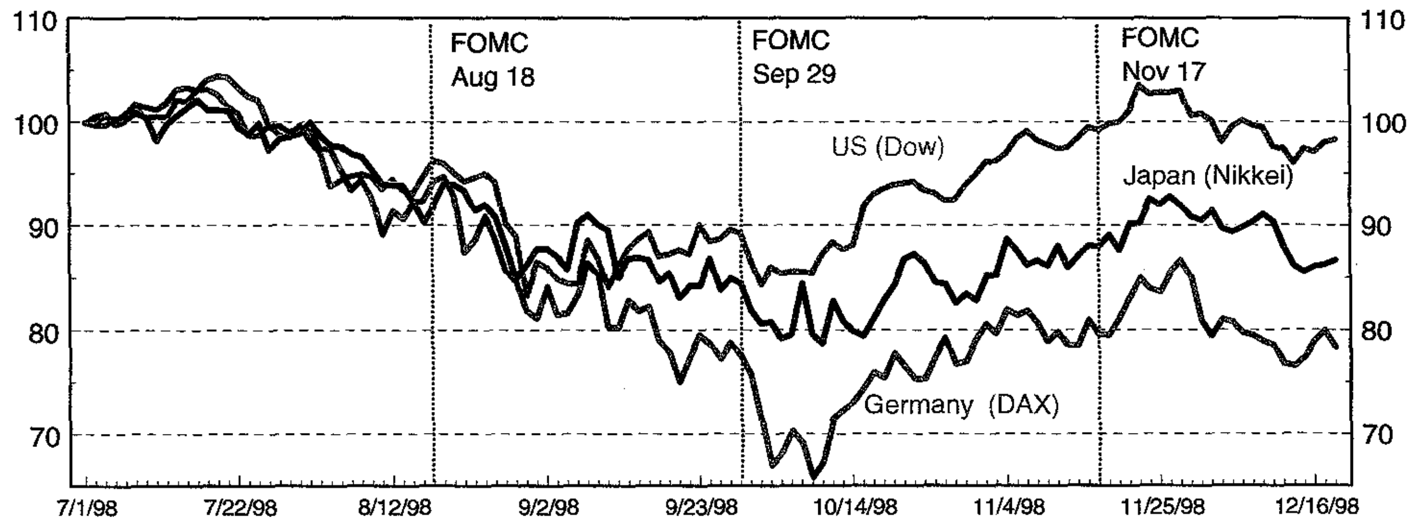


Chart: Hamsa M. Murthy

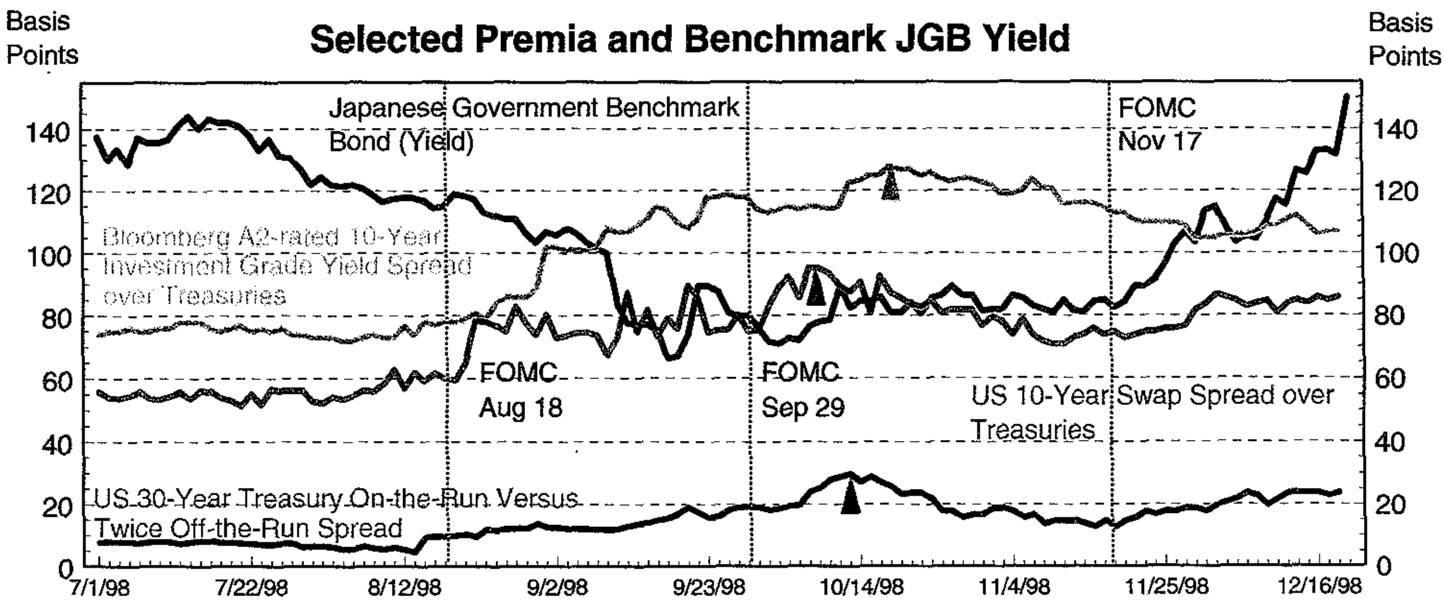
G-3 Currencies-- Indexed July 1= 100



G-3 Equity Indices-- Reindexed July 1= 100

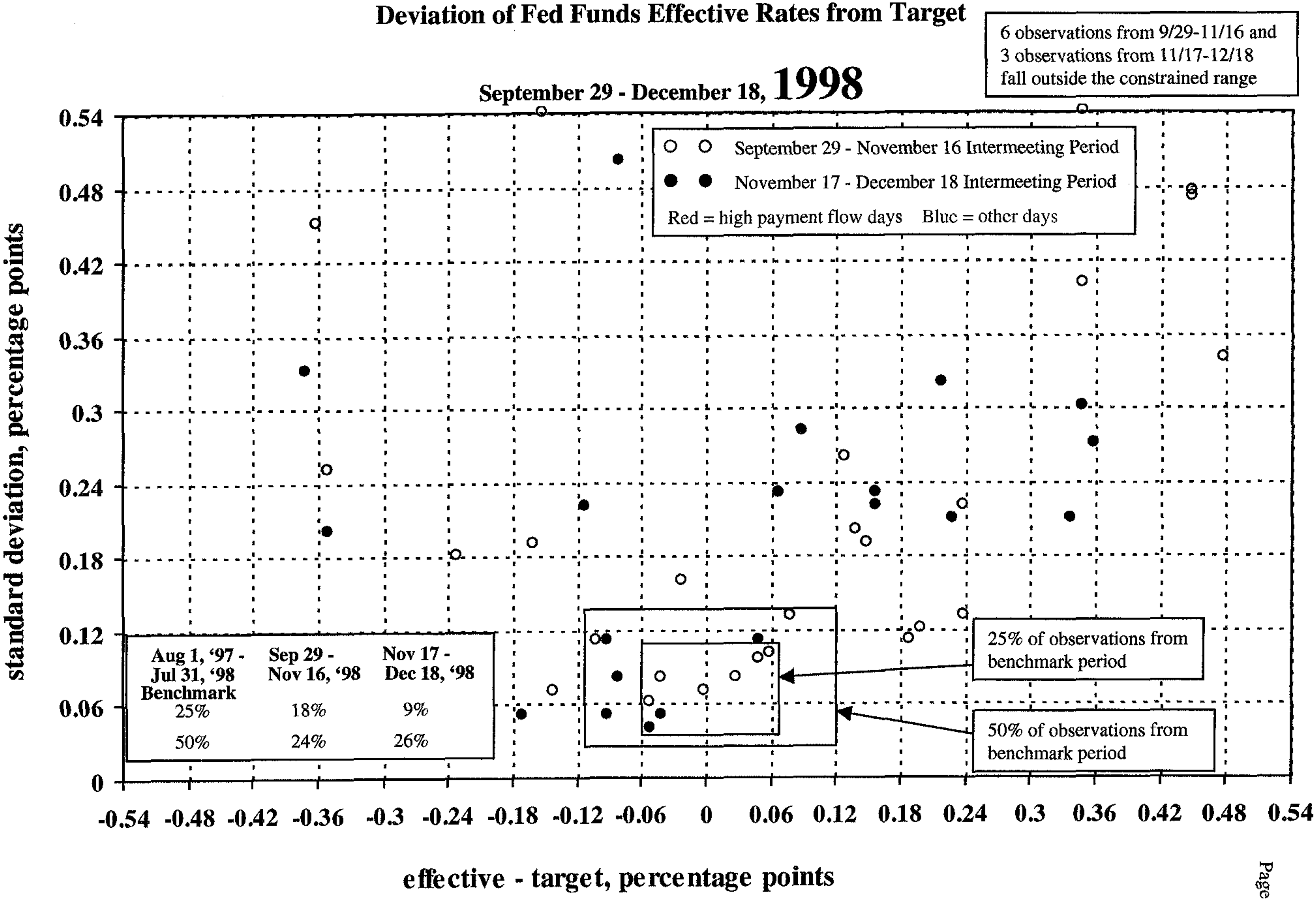


Selected Premia and Benchmark JGB Yield



Charts: Hamsa M. Murthy

Distribution of Daily Observations of One Standard Deviation of Fed Funds Trading Range and of Deviation of Fed Funds Effective Rates from Target



Distribution of Daily Observations of One Standard Deviation of Fed Funds Trading Range and of Deviation of Fed Funds Effective Rates from Target